

**Transco National Transmission System  
System Operator incentives 2004-2007**

**Licence modifications – shallow  
incentives**

March 2004

47/04

## Summary

Transco's National Transmission System (NTS) System Operator (SO) incentive scheme provides a number of incentives for Transco to carry out the day-to-day role of operating the NTS economically and efficiently. It is anticipated that this will lead to a reduction in the cost of system operation over time. A reduction in the costs of system operation should benefit customers who ultimately pay these costs.

A number of the day-to-day or "shallow" incentives included within the 2002 licence modifications had parameters that were set for a shorter duration than five years. This was due to uncertainties associated with likely future performance and was, therefore, intended to allow Ofgem to review the parameters after there had been some experience gained with how these incentives operated in practice. In addition Ofgem consulted upon changes to the exit capacity investment incentive, a "deep" incentive, where transitional arrangements had been put in place. Following a review of these incentives Ofgem consulted upon its proposals to modify Transco's Gas Transporter (GT) licence in February 2004.

Ofgem is proposing, in light of broad support for the proposals from the consultation respondents, to consult upon the licence modifications necessary to implement the proposed changes to the "shallow" system operator incentives, as outlined in its February 2004 consultation document. Ofgem intends to publish a second consultation document on changes to the deep system operator incentives in due course.

The Authority today gives notice pursuant to section 23(3) of the Gas Act 1986 to modify Special Condition 17, Special Condition 28 A, Special Condition 28 B 14, and Special Condition 33 that are contained in the GT Licence of Transco plc granted under section 7 of the Act in order to implement proposed changes to Transco's NTS SO incentive scheme. The proposed modifications can be found in Annex 1 to this notice.

The explanatory note attached in Annex 2 has been prepared to facilitate review of the section 23 notice issued today in respect of the proposed modifications to Transco's GT licence. As such, this note is intended to provide an explanation of various elements of the drafting so as to give legal and practical force to the policy objectives.



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# 1. Notice under Section 23(3) of the Gas Act 1986

The Gas and Electricity Markets Authority (the Authority) hereby gives notice pursuant to section 23(3) of the Gas Act 1986 (the Act) as follows:

1. The Authority proposes to modify Special Condition 17, Special Condition 28 A, Special Condition 28 B 14, and Special Condition 33 contained in the Gas Transporter Licence of Transco plc granted under section 7 of the Act to implement proposed changes to Transco's NTS SO incentive scheme. The proposed modifications can be found in Annex 1 to this notice. The proposed modification changes have been emboldened and italicised where they have been made to the Special Conditions.
2. The reasons why the Authority proposes to make these licence modifications and the effect of these modifications are summarised in Annex 2 to this notice. Further details of the proposed modifications were published by the Authority in the following documents:
  - a) *Transco's National Transmission System Review of System Operator incentives 2002-7: Scope of review - Open letter, August 2003;*
  - b) *Transco's National Transmission System Review of System Operator incentives 2002-7: Proposals Document, February 2004.*
3. The proposed modifications can be found in Annex 2 to this notice.
4. Copies of the documents referred to in paragraph 2 are available (free of charge) from the Ofgem Library, 9 Millbank, London, SW1P 3GE (020 7901 7003) or on the Ofgem website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)).
5. Any representations or objections with respect to the proposed modifications may be made on or before 31 March 2004 and should be addressed to Mr Kyran Hanks, Director of Wholesale Markets, 9 Millbank, London, SW1P 3GE or [Kyran.hanks@ofgem.gov.uk](mailto:Kyran.hanks@ofgem.gov.uk)



# Annex 1: Proposed Amendments to existing provisions of Transco's Gas Transporter licence

## AMENDMENT TO SPECIAL CONDITION 17

A proposed amendment to remove the requirement to provide Ofgem with an audit of Transco's Operational Guidelines (OGs)

### Special Condition 17

#### Paragraph 6

(b) <sup>1</sup>

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<sup>1</sup>*This paragraph is proposed to be removed by amendment to the special licence condition.*

## **AMENDMENT TO SPECIAL CONDITION 28A: Revenue restriction definitions**

### **Insertion of definitions for locational actions between the definition of LDZ transportation quantity and of long-term NTS SO baseline entry capacity**

Locational actions means any action taken by NGT where the action was taken in respect of a specific location and would therefore be coded with a locational reason code on the OCM. Locational buys will be treated as a cost to NGT and locational Sells will be treated as a revenue;



**AMENDMENT TO SPECIAL CONDITION 28 B Part 2 14**

**(7) Entry Capacity buy-back incentive**

**(a) Principal formula**

**Change to the definition of the Buy Back incentive target**

For the purposes of paragraph 14(2) of Part 2 of this Special Condition, the maximum buy-back incentive revenue allowed to the licensee in respect of formula year t ( $BBIR_t$ ) shall be derived in the following manner:

If  $BBIT_t^L > BBCP_t$ , then:

$$BBIR_t = \text{MIN} [BBUSF_t \times (BBIT_t^L - BBCP_t), BBCAP_t]$$

If  $BBIT_t^U < BBCP_t$ , then:

$$BBIR_t = \text{MAX} [BBDSF_t \times (BBIT_t^U - BBCP_t), BBCOL_t]$$

Otherwise:

$$BBIR_t = 0$$

where:

$BBIT_t^L$  means the lower buy-back incentive target in respect of formula year t as set out in the following table:

	<i>Formula year</i>
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<i>Variable</i>	<i>t = 1</i>	<i>t = 2</i>	<i>t ≥ 3</i>
$BBIT_t^L$ <i>£million</i>	<b>35</b>	<b>10</b>	<b>18</b>

$BBCP_t$  means the entry capacity buy-back performance measure in respect of formula year t and shall be calculated in accordance with paragraph 14(7)(b) of Part 2 of this Special Condition;

$MIN(x,y)$  means the value equal to the lesser of x and y;

$BBUSF_t$  is the buy-back upside sharing factor in respect of formula year t as set out in the following table:

	Formula year	
Variable	t = 1	t ≥ 2
$BBUSF_t$	50%	50%

$BBCAP_t$  means the maximum buy-back incentive revenue in respect of formula year t as set out in the following table:

	Formula year	
Variable	t = 1	t ≥ 2
$BBCAP_t$ <i>£million</i>	30	30

$BBIT_t^U$  means the upper buy-back incentive target in respect of formula year t as set out in the following table:

	<i>Formula year</i>		
<i>Variable</i>	<i>t = 1</i>	<i>t = 2</i>	<i>t ≥ 3</i>
$BBIT_t^U$ <i>£million</i>	<b>35</b>	<b>20</b>	<b>18</b>

MAX(x,y) means the value equal to the greater of x and y;

BBDSF<sub>t</sub> is the buy-back downside sharing factor in respect of formula year t as set out in the following table:

Variable	Formula year	
	t = 1	t ≥ 2
BBDSF <sub>t</sub>	35%	35%

BBCOL<sub>t</sub> means the minimum buy-back incentive revenue in respect of formula year t as set out in the following table:

Variable	Formula year	
	t = 1	t ≥ 2
BBCOL <sub>t</sub> £million	-12.5	-12.5

**(b) The entry capacity buy-back performance measure (BBCP<sub>t</sub>)**

**Changes to the definition of BBCP<sub>t</sub>, redefinition of ECCC<sub>d,t</sub>, and the insertion of three new terms.**

For the purposes of paragraph 14(7)(a) of Part 2 of this Special Condition, the entry capacity buy-back performance measure in respect of formula year t (BBCP<sub>t</sub>) shall be derived ***in the following manner:***

***In formula year (t ≤ 2)***

$$BBCP_t = IECCC_t - DDCR_t - REVIC_t - REVIEC_t - RCOR_t$$

***In formula year (t ≤ 3)***

$$BBCP_t = IECCC_t - DDCR_t - REVIC_t - REVIEC_t - RCOR_t - \mathbf{RLOC}_t$$

where:

$IECCC_t$  means an amount equal to the costs incurred by the licensee in respect of formula year t in respect of entry capacity constraint management and shall be derived from the following formula:

$$IECCC_t = \sum_{\text{all } d} BBC_{d,t} + \sum_{\text{all } d} ECCC_{d,t}$$

where:

$d$  means a day in formula year t;

$\sum_{\text{all } d}$  means the sum across all days  $d$  in formula year t of  $BBC_{d,t}$  or  $ECCC_{d,t}$ ;

$BBC_{d,t}$  means the costs incurred by the licensee in the curtailment of capacity rights to put gas into the transportation system in respect of day  $d$  of formula year  $t$  (including costs incurred in respect of any acquisitions from shippers of capacity rights); and

$ECCC_{d,t}$  **means in formula year ( $t \leq 2$ )** the costs incurred by the licensee in respect of any payments made by the licensee to shippers in exchange for agreeing to off-take gas from the NTS at the licensee's request on day  $d$ . in respect of formula year  $t$  and in respect of any costs incurred by the licensee undertaking any other commercial or physical action to manage

entry capacity excluding those covered by  $BBC_{d,t}$ ; **and**

**means in formula year ( $t \leq 3$ ) the costs incurred by the licensee in respect of any payments made by the licensee to shippers in exchange for agreeing to off-take gas from the NTS at the licensee's request on day  $d$  in respect of formula year  $t$  and in respect of any costs incurred by the licensee undertaking any other commercial or physical action to manage entry capacity excluding those covered by  $BBC_{d,t}$  including any locational buy actions.**

$DDCR_t$  means the revenue derived by the licensee in respect of on-the-day sales of obligated entry capacity in respect of formula year  $t$  and shall be derived from the following formula:

$$DDCR_t = DREVBEC_t + DREVOIEC_t$$

where:

$DREVBEC_t$  shall have the meaning given to that term in paragraph 14(5)(I)(i) of Part 2 of this Special Condition; and

$DREVOIEC_t$  shall have the meaning given to that term in paragraph 14(5)(I)(ii) of Part 2 of this Special Condition;

REVIC<sub>t</sub> shall have the meaning given to that term in paragraph 13(2) of Part 2 of this Special Condition;

REVIEC<sub>t</sub> shall have the meaning given to that term in paragraph 14(5)(k)(iii) of Part 2 of this Special Condition; and

RCOR<sub>t</sub> Shall have the meaning given to that term in paragraph 13(3) of Part 2 of this Special Condition.

**RLOC<sub>t</sub> means the revenue derived by the licensee in respect of formula year t in respect of locational sell actions and physical renomination incentive charges (having the meaning given to that term in the licensee's Network Code) and shall be derived from the following formula:**

$$RLOC_t = \sum_{all\ d} RLSA_{d,t} + \sum_{all\ d} RPIC_{d,t}$$

**where:**

**RLSA<sub>d,t</sub> means the revenue derived by the Licensee in respect of locational sell actions in respect of day d of formula year t; and**

**RPIC<sub>d,t</sub> means the revenue derived by the licensee in respect of a physical renomination incentive charge (having the meaning given to that term in the licensee's Network Code) in respect of day d of formula year t.**

(8) **System balancing incentive**

(c) **The maximum system reserve incentive revenue (SRIR<sub>t</sub>)**

**Amendment to the definition of SRCP<sub>t</sub>**

SRCP<sub>t</sub> means the system reserve performance measure in respect of formula year t and shall be the total payments made by the licensee in respect of costs incurred by the licensee in respect of storage capacity **or LNG Importation capacity that has been paid or gas delivery service fee that has been paid** for the purposes of satisfying operational margins requirements (having the meaning given to that term in the licensee's Network Code);

(e) **The NTS SO gas cost reference price (GCRP<sub>t</sub>)**

**Change to the definition of FQRP as defined in paragraph (ii)**

FQRP<sub>t,q</sub> means the forward quarterly reference price in respect of quarter q of formula year t and shall be derived from the following formula:

$$FQRP_{t,q} = \frac{\sum_{d=a}^b FP_{t,q,d}}{n}$$

where:

a ***In respect of formula years (t ≤ 3) means 1 March in formula year (t-1) and in respect of formula years (t ≥ 4) 1 April in formula year***

**(t-1);**

b ***In respect of formula years (t ≤ 3) means 20 March in formula year (t-1) and in respect of formula years (t ≥ 4) 31 March in formula year (t-1);***

$\sum_{d=a}^b$

means the sum of all business days d between day a and day b (both inclusive);

FP<sub>t,q,d</sub>

means the forward price quoted in an approved published price reporting service on day d for a gas contract for delivery at the national balancing point (having the meaning given to that term in the published price reporting service approved in accordance with sub-paragraph (iii) below) in respect of quarter q of formula year t, measured in p/kWh; and

n

means the number of business days between a and b inclusive.

## **(9) Residual gas balancing incentive**

### **(f) The daily residual balancing price performance measure (PPM<sub>d,t</sub>)**



**Amendments to the balancing price performance measure (PPM<sub>d,t</sub>) to change the definitions of TMIBP<sub>d,t</sub>, TMISP<sub>d,t</sub> and to remove the '1/2' from the calculation of PPM<sub>d,t</sub>.**

For the purposes of paragraph 14(9)(e) of Part 2 of this Special Condition, the licensee's daily residual balancing price performance measure in respect of day d in formula year t (PPM<sub>d,t</sub>) shall be derived from the following formula:

$$PPM_{d,t} = \left( \frac{(TMIBP_{d,t} - TMISP_{d,t})}{SAP_{d,t}} \right) \times 100$$

where:

TMIBP<sub>d,t</sub> **means in formula year** ( $t \leq 2$ ) the price in pence per kilowatt hour which is equal to the highest market offer price (having the meaning given to that term in the licensee's Network Code) in relation to a eligible balancing action (having the meaning given to that term in the licensee's Network Code) taken in respect of day d of formula year t unless the licensee took no such eligible balancing action in which case TMIBP<sub>d,t</sub> will equal SAP<sub>d,t</sub> ;  
**and**

**means in formula year** ( $t \leq 3$ ) the price in pence per kilowatt hour which is equal to the highest market offer price (having the meaning given to that term in the licensee's Network Code) in relation to a eligible balancing action (having the meaning given to that term in the licensee's Network Code) taken in respect of day d of formula year t unless the licensee took no such eligible balancing action in which case TMIBP<sub>d,t</sub> will equal SAP<sub>d,t</sub>.

TMISP<sub>d,t</sub> **means in formula year ( $t \leq 2$ )** the price in pence per kilowatt hour which is equal to the highest market offer price (having the meaning given to that term in the licensee's Network Code) in relation to a eligible balancing action (having the meaning given to that term in the licensee's Network Code) taken in respect of day d of formula year t unless the licensee took no such eligible balancing action in which case TMISP<sub>d,t</sub> will equal SAP<sub>d,t</sub> ;  
**and**

**means in formula year ( $t \leq 3$ ) the price in pence per kilowatt hour which is equal to the highest market offer price (having the meaning given to that term in the licensee's Network Code) in relation to a eligible balancing action (having the meaning given to that term in the licensee's Network Code) excluding any locational actions taken in respect of day d of formula year t unless the licensee took no such eligible balancing action in which case TMISP<sub>d,t</sub> will equal SAP<sub>d,t</sub> .**

SAP<sub>d,t</sub> means the system average price (having the meaning given to that term in the licensee's Network Code) in respect of day d of formula year t

## AMENDMENT TO SPECIAL CONDITION 33

### Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction

#### Amendment to the information to be provided in connection with the Entry capacity buy-back incentive

Entry capacity buy-back incentive information			
IECCC <sub>t</sub>	Total entry capacity constraint management costs	Formula year	By 30 June in formula year t+ 1
IECCC <sub>t</sub>	Total entry capacity constraint management costs	Year to date	Monthly 2 weeks after month end
BBIR <sub>t</sub>	Entry capacity buy-back incentive revenue	Formula year	By 30 June in formula year t+ 1
BBIR <sub>t</sub>	Cumulative balance and end of year forecast of entry capacity buy-back incentive revenue	Year to date	Monthly 4 weeks after month end
BBCP <sub>t</sub>	Entry capacity buy-back performance measure	Formula year	By 30 June in formula year t+ 1
BBCP <sub>t</sub>	Entry capacity buy-back performance measure	Year to date	Monthly 4 weeks after month end
BBC <sub>d,t</sub>	Entry capacity buy back costs	day	D + 1
	Volume and prices of entry capacity buy-backs by terminal	day	D + 1
ECCC <sub>d,t</sub>	Entry capacity constraint payments	day	D + 1
	Revenue from daily sales of obligated entry capacity	day	D + 1

	Volumes and prices of obligated entry capacity sold daily by terminal	day	D + 1
	Revenue from sales of interruptible entry capacity	day	D + 1
	Volumes and prices of sales of interruptible entry capacity identifying volumes of use it or lose it entry capacity by terminal	day	D + 1
	Revenue from sales of non-obligated incremental system entry capacity	day	D + 1
	Volumes and prices of non-obligated incremental system entry capacity by terminal	day	D + 1
<b><i>RLOC<sub>t</sub></i></b>	<b><i>Revenue from locational sell actions</i></b>	<b><i>Formula year</i></b>	<b><i>For formula years t ≤ 3 by 30 June in formula year t + 1</i></b>
	<b><i>Volumes, locations and prices of locational trades by trade</i></b>	<b><i>day</i></b>	<b><i>For formula years t ≤ 3 D + 1</i></b>
<b><i>RCOR<sub>t</sub></i></b>	Revenue from system entry overrun charges	Monthly	4 weeks after month end
	Volume and prices of system entry capacity overruns by terminal	Monthly	4 weeks after month end
	Volume of system entry capacity terminal flow advice issued by	Monthly	4 weeks after month end

	Transco and any associated costs		
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<sup>6</sup> *Transco's National Transmission System Review of System Operator incentives 2002-7: Proposals Document*, February 2004

## Annex 2: Explanatory notes

### *Introduction*

- 2.1 A number of the day-to-day or “shallow” incentives included within the 2002 licence modifications had parameters that were set for less than five years. This was due to uncertainties associated with likely future performance and was, therefore, intended to allow Ofgem to review the parameters after there had been some experience gained with how these incentives operated in practice. In addition Ofgem consulted upon changes to the exit capacity investment incentive, a “deep” incentive, where transitional arrangements had been put in place. Following a review of these incentives Ofgem consulted upon its proposals to modify Transco’s Gas Transporter (GT) licence in February 2004.
- 2.2 Ofgem is proposing, in light of broad support for the proposals from the consultation respondents, to consult upon the licence modifications necessary to implement the proposed changes to the shallow system operator incentives, as outlined in its February 2004 consultation document. Ofgem intends to publish a second consultation document on changes to the deep system operator incentives in due course.
- 2.3 This explanatory note has been prepared to facilitate review of the section 23 notice issued today by Ofgem in respect of the proposed modifications to Transco’s gas transporter (GT) licence to introduce, from 1 April 2004 changes to Transco’s NTS SO incentive scheme. As such, this note aims to provide an explanation of elements of the drafting so as to give legal and practical force to the policy objectives set out in Ofgem’s February 2004 proposals document<sup>6</sup>.

### *February consultation process*

- 2.4 Following a review of these incentives Ofgem consulted upon its proposals to modify Transco’s Gas Transporter licence. The consultation period ended on 20 February.

- 2.5 Responses were received from seven participants, including National Grid Transco (NGT), all of which were non-confidential and are available from the Ofgem website.

#### **Exit Capacity Investment incentive**

- 2.6 Except for NGT, all of the respondents who commented on this issue believed that it was appropriate to minimise the exit capacity cap and collar whilst the exit arrangements were under review. NGT did not consider that a case had been made for a large reduction in the caps and collars. Instead it indicated that it would support a phased reduction. All respondents supported the proposal to remove the requirement from the licence for Transco to introduce universal firm NTS exit registration on a reasonable endeavours basis by 1 April 2004 or as soon as reasonably practicable thereafter.

#### **Entry Capacity buy-back incentive**

- 2.7 Respondents had mixed views on the level at which Ofgem proposed to set the buy back target with three respondents feeling that the target was too high and three respondents feeling that the level was appropriate. NGT responded that, based upon their own modelling, there was higher risk on the cost side than on the revenue side, and that this should be considered in the setting of the buy back target.
- 2.8 Concerning the inclusion of locational actions, four respondents were supportive, of the other three, one stated that they would require further information concerning their intersubstitutability to be able to comment and another did not comment on this issue. NGT did not support their inclusion believing that they were not used interchangeably with capacity actions and because appropriate network code modifications would need to be developed. In addition, three of the four respondents who commented upon the issue supported the inclusion of overruns within the target.

#### **Residual gas balancing incentive**

- 2.9 All respondents commented upon the appropriateness of deepening the level of Transco's exposure under this incentive through the removal of the '1/2' from

the price performance measure. All respondents were in favour of Ofgem's proposal with the exception of NGT. NGT considered that experience to date does not justify the deepening of the incentive.

### **System balancing incentive**

- 2.10 All of the five respondents who commented upon Transco's proposal for an adjustment to the calculation of the gas cost reference price supported the proposal. Only one respondent commented upon the appropriateness of changing the definition of the system reserve performance measure, and concurred with Ofgem that a consistent approach must be applied to the wording of the code and the licence.

### **Internal cost incentive**

- 2.11 A number of the five respondents who commented upon the issue of retaining the current internal cost incentive scheme parameters felt that Ofgem's proposal was appropriate. A number of respondents highlighted the need for Ofgem to address the issue of differences between SO and TO, and gas and electricity internal incentives, as the schemes are developed.

### **Other areas**

- 2.12 All respondents commented upon the appropriateness of retaining the requirement on Transco to produce Operational Guidelines (OGs). All were in favour of Ofgem's proposal with the exception of NGT. NGT considered that the requirement creates unnecessary costs with little additional benefit. All respondents who commented on Ofgem's proposal to remove the requirement on Transco to produce separate auditor's statements were in favour.
- 2.13 Of the five respondents who commented all were in agreement with Ofgem's proposal not to introduce a gas quality incentive at this time in light of the review currently being carried out by Ofgem and the DTI.

### ***Ofgem's Proposals***

- 2.14 Ofgem now proposes to make the licence amendments detailed in Annex 1, and explained further below. Ofgem has decided to split the incentives into shallow



and deep incentives and to consult separately upon each. Shallow incentives are those that only cover the costs of operating the NTS on a day-to-day basis and include the entry capacity buy-back incentive, the system balancing incentive and the residual gas balancing incentive.

- 2.15 Ofgem is proposing, in light of broad support for the proposals from the consultation respondents, to consult upon the licence modifications necessary to implement the proposed changes to the shallow system operator incentives, as outlined in its February 2004 consultation document. Ofgem intends to publish a second consultation document on changes to the deep system operator incentives in due course.

#### **Entry Capacity Buy-Back incentive (Special Condition 28 B 14 (7))**

- 2.16 The target, sharing factors and caps and collars for the NTS entry capacity buy-back scheme was set for two years to reflect the degree of uncertainty about the actual costs Transco would incur in managing NTS entry capacity constraints. At the time, there was limited experience with a number of features of the NTS entry capacity buy-back arrangements and Ofgem believed that another 18 months experience with the regime would improve the setting of incentive parameters over the longer term. In the light of this experience Ofgem proposed to set the entry capacity buy-back incentive target at £18m for 2004/5, 2005/6 and 2006/7.
- 2.17 In addition, Ofgem proposed to include the costs of locational actions within the entry capacity buy back target. Ofgem considers that locational gas balancing actions taken on the Over-the-Counter Mechanism (OCM) to remedy locational network constraints may have a similar impact to buying back entry capacity rights in that both function as constraint management tools. Due to this substitutability, not including locational gas in the scheme could allow Transco to use such actions to manage capacity constraints without being required to bear any of the costs and this could bias Transco's use of which balancing tool to use. Ofgem considers that incentivising Transco to make more efficient decisions when deciding which balancing tool to use would allow Transco to more efficiently incur balancing costs.

2.18 These proposals have also necessitated a number of drafting changes to the residual gas balancing incentive (paragraph 9 (f)) since currently Transco is incentivised with regards to locational trades by way of its residual gas balancing incentive. Amendments have also been proposed to Special Condition 28A and Special Condition 33 as a consequence of the proposal to include locational balancing actions within the buy-back incentive. Special Condition 28A provides definitions for the revenue restriction terms utilised in Special Condition 28 B Parts 1 and 2. Special Condition 33 lists information to be provided to the authority to include details of locational trades within the list of data provided in connection with the entry capacity buy-back incentive.

### **System Balancing Incentive (Special Condition 28 B 14 (8))**

#### *Gas Cost*

2.19 The target costs for own use, unbilled and unaccounted for gas is calculated by a formula set out in the licence and the formula was intended to remain in place for the full five years of the incentive period. This formula uses the target volume of such gas and the associated reference price ('the gas cost reference price', or GCRP) of that gas. The reference price is calculated on the basis of using quoted forward prices for the year in question on the following basis; average quarterly forward prices are derived as the mean of NBP forward quarterly prices published by a gas price reporting service (e.g. Heren) between 1 March and 20 March of the formula year immediately prior to the year that GCRP will apply.

2.20 Transco brought to Ofgem's attention some potential market impacts associated with the relatively short window under which forward prices are averaged. In particular, Transco has suggested that responding to the incentive by sourcing such large volumes in such a small window (in excess of 8TWh) might be expected to have a significant impact on the cost of the gas itself.

2.21 Ofgem in its February 2004 proposals document outlined an alternative proposal which:

- ◆ for formula year 2005/6 proposed that the reference price could be based on the average of the quoted relevant forward prices across the period covered by the latest of the first calendar month following the implementation of the Section 23 licence modifications and 31 March 2005; and
- ◆ for formula year 2006/7 the reference price should be based on the average of the quoted relevant forward prices across the whole of the preceding formula year.

#### *System Reserve*

- 2.22 Ofgem did not propose to make any changes to the sharing factors for system reserve. Ofgem put in place 100 per cent sharing factors for the initial two year period due to the common ownership of the LNG facilities. Ofgem noted that NGT still retains ownership of the LNG facilities and the cost of OM capacity is incurred largely at these facilities. Ofgem also proposed no changes to the target currently allowed for the purchase of OMs (and the associated special condition 9D prices as set out in Transco's GT licence) as a short term measure.
- 2.23 To reflect the proposed network code modification changing the status of Isle of Grain, Ofgem proposed to reword the definition of the System Reserve Performance Measure (SRCP) to include the costs of capacity incurred in respect of LNG Importation capacity.

#### **Residual Gas Balancing Incentive (Special Condition 28 B 14 (9))**

- 2.24 Ofgem set the parameters for undertaking residual gas balancing for two years, in recognition of the uncertainty with regard to various factors, including: the operation of the gas regime following the reform to the cash-out arrangements for shippers' in June 2001<sup>7</sup>; the introduction of the linepack incentive in June 2001 (the price incentive had been in place since October 1999); and the

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<sup>7</sup> In April 2001, the cash-out regime was changed following the implementation of Modification Proposal 0433. SMP-Buy and SMP-Sell were set at fixed differentials above and below (respectively) SAP. These differentials apply on days when Transco either takes no balancing actions, or the prices of its actions were closer to SAP than SAP plus the relevant fixed differential.

removal of imbalance tolerances in April 2001<sup>8</sup>. Ofgem reviewed the parameters of the residual gas balancing incentive, in the light of over two years worth of data concerning the operation of the regime becoming available, since the significant changes outlined above.

- 2.25 Ofgem proposed to deepen Transco's exposure under this incentive by an adjustment to the calculation of the price performance measure. When the incentive was put in place a '1/2' was introduced into the formula used for the calculation of the price performance measure so that Transco's trading performance was measured against half of the spread between Transco's lowest and highest trade. Ofgem has proposed to remove the '1/2' from the formula. The deepening of the incentive will expose Transco to the full spread in prices and should encourage Transco to trade closer to SAP.

#### **Operational Guidelines – Special Condition 17**

- 2.26 Transco is required to produce a System Management Principles statement (SMP) in order to provide transparency in its role as system operator. In addition Transco has an ongoing licence obligation to produce Operational Guidelines (OGs). To a large extent, OGs perform a similar information role on a national and localised level. It was Ofgem's original intention that Transco's requirement to produce Procurement Guidelines (PGs) and SMPs would replace Transco's obligations to produce OGs under special condition 17.
- 2.27 However, as stated in the February 2004 proposals document Ofgem continues to have concerns that the content of the statements are not sufficiently robust and developed to remove Transco's need to produce OGs. Ofgem also considered that any reconsideration of special condition 17 would need to address any obligations that may need to be developed in its function as system operator and potentially as distribution network operator. It was Ofgem's view that the obligation should stay in place until the issue of the potential sale of Transco's distribution networks is resolved. However Ofgem did propose to

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<sup>8</sup> In April 2001, all imbalance tolerances were removed with the exception of the "forecast deviation tolerance". This form of tolerance was subsequently removed on 1 October 2002.

remove the requirement to produce separate auditor's statements for OGs and SMPs.