

To: The Company Secretary
Transco plc (Company number:2006000)
1-3 Strand
London
WC2N 5EH

MODIFICATION OF TRANSCO PLC'S GAS TRANSPORTERS LICENCE PURSUANT TO SECTION 23 OF THE GAS ACT 1986

Whereas:

1. Transco ('the Licensee') is the holder of a licence ('the Licence') treated as granted under Section 7 of the Gas Act 1986 ('the Act'), to convey gas through pipes to any premises in the specified area in schedule 1 of the Licence and to convey gas through pipes to any pipeline system operated by another gas transporter, for the term and upon the conditions specified in the licence.
2. Pursuant to section 23(3) of the Act, on 3 March 2004 the Authority published a notice stating that it proposed to modify the Licence ('the Notice'). Documentation explaining the proposed modifications was also published at this time. In the Notice the Authority:
 - (i) stated that it proposed to modify the Licence by amending or inserting therein (as the case may be) conditions and schedule provisions numbered and entitled:
 - (a) Special Condition 17;
 - (b) Special Condition 28A ;
 - (c) Special Condition 28B; and
 - (d) Special Condition 33.and
 - (ii) published the notice in the manner it considered appropriate.
3. Prior to the close of the consultation period some errors in the licence amendments and a drafting omission were brought to the attention of the Authority. The drafting omission was in respect of Special Condition 28B. The Authority brought these matters to the attention of interested parties by way of an open letter on 23 March 2004 that detailed the errors and the omission.
4. The Authority gave notice to the Secretary of State for Trade and Industry of its proposal to make the modification and did not receive any objection, or direction not to proceed.

Appendix 1

Transco SO Incentives 2004-07

**Modifications to the Gas Transporter
Licence of Transco plc which shall take
effect on 1 April 2004 by virtue of a
direction to modify the licence issued by
the Authority on 1 April 2004**

SPECIAL CONDITION 17

To remove the requirement to provide Ofgem with an audit of Transco's Operational Guidelines (OGs) from paragraph 6

Special Condition 17

Paragraph 6

*(b)*¹

¹This paragraph was 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 the licensee 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 the licensee and locational Sells will be treated as a revenue;

AMENDMENT TO SPECIAL CONDITION 28 B Part 2 13

NTS system operation revenue (SOR_t)

(1) Principal formula

For the purposes of paragraph 12 of Part 2 of this Special Condition the revenues which the licensee derives from its NTS system operation activity in respect of any formula year t (SOR_t) shall be derived from the following formula:

$$\text{SOR}_t = \text{RCOM}_t + \text{SOExRF}_t + \text{SORCAP}_t + \text{SOROC}_t$$

where:

RCOM_t means the revenue derived by the licensee in respect of formula year t from charges levied on shippers pursuant to amended standard condition 4 (Charging Gas Shippers – General) in respect of NTS SO activities provided by the licensee and shall include charges to recover both costs incurred by the licensee and net payments made to or by the licensee in respect of reducing the costs arising from system operation activities other than revenue earned by the licensee through (i) **SOExRF_t** (ii) **SORCAP_t** and (iii) **SOROC_t**.

SOExRF_t means the revenue derived by the licensee in respect of formula year t from sales of incremental exit capacity and shall be derived in accordance with the following formula:

$$\text{SOExRF}_t = \text{TOEx}_t - \text{TOExRF}_t$$

where:

TOEx_t shall be derived in accordance with paragraph 2 of Part 1 a of this Special Condition;

TOExRF_t shall be derived in accordance with paragraph

2 of Part 1 a of this Special Condition;

$SORCAP_t$ means the NTS SO revenue derived by the licensee in respect of sales of entry capacity and shall be derived in accordance with paragraph 13(2) of Part 2 of this Special Condition; and

$SOROC_t$ means the NTS SO revenue derived by the licensee in respect other defined SO charges and shall be derived in accordance with paragraph 13(3) of Part 2 of this Special Condition.

(2) NTS SO revenue derived from the sales of entry capacity ($SORCAP_t$)

For the purposes of paragraph 13(1) of Part 2 of this Special Condition NTS SO revenue derived by the licensee in respect of sales of entry capacity in respect of formula year t ($SORCAP_t$) shall be derived from the following formula:

$$SORCAP_t = DREVBEC_t + REVOIEC_t + REVIEC_t + REVIC_t + REVIBEC_t$$

where:

$DREVBEC_t$ means the revenue derived by the licensee in respect of formula year t from on the day sales of NTS SO baseline entry capacity and shall be derived in accordance with paragraph 14(5)(l)(i) of Part 2 of this Special Condition;

$REVOIEC_t$ means the revenue derived by the licensee in respect of formula year t from sales of obligated incremental entry capacity and shall be derived in accordance with paragraph 14(5)(k)(ii) of Part 2 of this Special Condition;

$REVIEC_t$ means the revenue derived by the licensee in respect of formula year t from sales of non-obligated incremental entry capacity and shall be derived in accordance with paragraph 14(5)(k)(iii) of Part 2 of this Special Condition;

$REVIC_t$ means the revenue derived by the licensee in respect of formula

year t from sales of interruptible entry capacity; and

$REVIBEC_t$ means the revenues earned by the licensee in respect of formula year t from sales of permanent obligated incremental entry capacity relating to periods more than 5 years after the first day to which such capacity is related and shall be derived in accordance with paragraph 14(5)(k)(iv) of Part 2 of this Special Condition.

(3) Associated SO charges ($SOROC_t$)

For the purposes of paragraph 13(1) of Part 2 of this Special Condition NTS SO revenue derived by the licensee through associated SO charges in respect of formula year t ($SOROC_t$) shall be derived from the following formula:

In formula year ($t \leq 2$)

$$SOROC_t = RNC_t + RCOR_t + FTI_t$$

In formula year ($t \geq 3$)

$$SOROC_t = RNC_t + RCOR_t + FTI_t + RLOC_t$$

where:

RNC_t means the net revenue derived in respect of formula year t through balancing neutrality charges (having the meaning given to that term in the licensee's Network Code);

$RCOR_t$ means revenue derived by the licensee in formula year t in respect of system entry overrun charges (having the meaning given to that term in the licensee's Network Code); and

FTI_t means revenue derived by the licensee in respect of formula year t from charges levied on shippers in respect of any failure to interrupt

(having the meaning given to that term in the licensee's Network Code).

RLOC_t 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 in accordance with paragraph 14(7)(b) of Part 2 of this Special Condition

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:

Variable	Formula year		
	t = 1	t = 2	t ≥ 3
$BBIT_t^L$ £million	35	10	18

$BBCP_t$ 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:

Variable	Formula year	
	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:

Variable	Formula year	
	t = 1	t ≥ 2
$BBCAP_t$ £million	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:

Variable	Formula year		
	t = 1	t = 2	t ≥ 3

BBIT _t ^U £million	35	20	18
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MAX(x,y) means the value equal to the greater of x and y;

BBDSF_t is the buy-back downside sharing factor in respect of formula year t as set out in the following table:

	Formula year	
Variable	t = 1	t ≥ 2
BBDSF _t	35%	35%

BBCOL_t means the minimum buy-back incentive revenue in respect of formula year t as set out in the following table:

	Formula year	
Variable	t = 1	t ≥ 2
BBCOL _t £million	-12.5	-12.5

(b) The entry capacity buy-back performance measure (BBCP_t)

Changes to the definition of BBCP_t, redefinition of ECCC_{d,t}, 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_t) shall be derived in the following manner:

In formula year (t ≤ 2)

$$\text{BBCP}_t = \text{IECCC}_t - \text{DDCR}_t - \text{REVIC}_t - \text{REVIEC}_t - \text{RCOR}_t$$

In formula year (t ≥ 3)

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

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 ($t \geq 3$) 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;

$REVIC_t$ shall have the meaning given to that term in paragraph 13(2) of Part 2 of this Special Condition;

REVIEC_t shall have the meaning given to that term in paragraph 14(5)(k)(iii) of Part 2 of this Special Condition; and

RCOR_t Shall have the meaning given to that term in paragraph 13(3) of Part 2 of this Special Condition.

RLOC_t 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_{d,t} means the revenue derived by the Licensee in respect of locational sell actions in respect of day d of formula year t; and

RPIC_{d,t} 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_t)

Amendment to the definition of SRCP_t

$SRCP_t$ 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 for 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_t)

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

$FQRP_{t,q}$ 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 ($t \leq 3$) means 1 March in formula year (t-1) and in respect of formula years ($t \geq 4$) 1 April in formula year (t-1);
- b In respect of formula years ($t \leq 3$) means 20 March in formula year (t-1) and in respect of formula years ($t \geq 4$) 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);

$FP_{t,q,d}$

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_{d,t})

Amendments to the balancing price performance measure (PPM_{d,t}) to change the definitions of TMIBP_{d,t}, TMISP_{d,t} and to remove the '1/2' from the calculation of PPM_{d,t}.

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_{d,t}) shall be derived from the following formula:

In formula year $t \leq 2$

$$PPM_{d,t} = \frac{1}{2} \times \left(\frac{(TMIBP_{d,t} - TMISP_{d,t})}{SAP_{d,t}} \right) \times 100$$

In formula year $t \geq 3$

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

where:

$TMIBP_{d,t}$ 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 $TMIBP_{d,t}$ will equal $SAP_{d,t}$;
and

means in formula year ($t \geq 3$) 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 $TMIBP_{d,t}$ will equal $SAP_{d,t}$.

$TMISP_{d,t}$ means in formula year ($t \leq 2$) the price in pence per kilowatt hour which is equal to the lowest 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 $TMISP_{d,t}$ will equal $SAP_{d,t}$;

and

means in formula year ($t \geq 3$) the price in pence per kilowatt hour which is equal to the lowest 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 $TMISP_{d,t}$ will equal $SAP_{d,t}$.

$SAP_{d,t}$

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 _t	Total entry capacity constraint management costs	Formula year	By 30 June in formula year t+ 1
IECCC _t	Total entry capacity constraint management costs	Year to date	Monthly 2 weeks after month end
BBIR _t	Entry capacity buy-back incentive revenue	Formula year	By 30 June in formula year t+ 1
BBIR _t	Cumulative balance and end of year forecast of entry capacity buy-back incentive revenue	Year to date	Monthly 4 weeks after month end
BBCP _t	Entry capacity buy-back performance measure	Formula year	By 30 June in formula year t+ 1
BBCP _t	Entry capacity buy-back performance measure	Year to date	Monthly 4 weeks after month end
BBC _{d,t}	Entry capacity buy back costs	day	D + 1
	Volume and prices of entry capacity buy-backs by terminal	day	D + 1
ECCC _{d,t}	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	day	D + 1

	terminal		
	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
RLOC _t	Revenue from locational sell actions	Formula year	For formula years $t \geq 3$ by 30 June in formula year $t + 1$
	Volumes, locations and prices of locational actions by trade	day	For formula years $t \geq 3$ D + 1
RCOR _t	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 Transco and any associated costs	Monthly	4 weeks after month end

Modification Proposals to Transco's Gas Transporter Licence in relation to changes to Transco's National Transmission System (NTS) System Operator (SO) Incentives scheme from 1 April 2004

Background to the modification proposals and summary of responses received

Introduction

On 03 March 2004, the Authority issued a statutory notice (Notice) under section 23 (3) of the Gas Act 1986 ('The Act') together with an accompanying document¹, setting out proposed modifications to Transco's gas transporter (GT) licence necessary to facilitate relation to changes to Transco's NTS SO Incentives scheme from 1 April 2004.

The licence modification consultation period closed on 31 March 2004.

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

Background

Transco's NTS 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.

Section 23 Consultation

Ofgem, in light of broad support for the proposals from the consultation respondents, gave notice on 03 March 2004 pursuant to section 23(3) of the Gas Act 1986 to modify Special Condition 17, Special Condition 28 A, Special Condition 28 B, and Special Condition 33 order to implement proposed changes to the shallow Transco's NTS SO incentive scheme. Ofgem, in its guidance note which accompanied the March 2004 Section 23 Notice and proposed modifications, stated its decision to split the incentives into shallow and deep incentives and to consult separately upon each. In addition Ofgem indicated that it intended to publish a second consultation document on changes to the deep system operator incentives in due course.

¹ *Transco's National Transmission System Review of System Operator incentives 2002-7: Proposals Document, February 2004*

Prior to the close of the consultation period a number of drafting errors and a drafting omission were brought to the attention of the Authority in the response submitted by Transco. In order to better facilitate the consultation process concerning the changes proposed to Transco's Gas Transporter Licence, Ofgem published an open letter on 23 March 2004 giving details of the errors.

Ofgem received responses from two respondents in addition to Transco, both of the responses were not marked as confidential and copies have been placed on Ofgem's website. Both respondents were broadly supportive of the proposed modifications to Transco's day-to-day "shallow" SO incentive. Ofgem on the 01 April 2004 received Transco's letter of acceptance to the proposed modifications.

Entry Capacity Buy Back Incentive

Respondent's views

One respondent was concerned that the drafting of the modification provided for all locational actions taken by Transco to be attributed to the entry capacity buy-back (ECBB) incentive. The respondent questioned whether this is appropriate and whether only those that are made in order to address entry capacity constraint issues should be treated in this way. Furthermore, the respondent questioned the appropriateness of including revenue from the sale of locational gas within the ECBB incentive.

The other respondent, whilst also being concerned that the modification provided for all locational actions to be included within the ECBB incentive, felt that there was a stronger case for the inclusion of revenues from locational sells to be included within the ECBB incentive than for the costs of locational buys since they considered it likely that Transco would substitute between entry capacity buy backs and locational sells at a particular entry point on the system. This respondent also raised concerns that locational issues taken for energy constraint reasons should not be included within the ECBB incentive.

Transco's views

Transco's key concern relates to the inclusion of locational actions within the entry capacity buy-back scheme. Transco continues to oppose this as a matter of principle, i.e. that locational actions are not used interchangeably with capacity actions.

Transco also voiced concerns about the practical implementation of the proposal in that the change requires relatively extensive Licence modifications with consequential impacts upon the Network Code, and that system changes would be required to support the changed treatment.

Ofgem's views

In our conclusions document on the summer supply interruptions² that occurred in June 2003, Ofgem considered that locational gas balancing actions, which are taken on the OCM to remedy locational network/system constraints, may have a similar impact to buying back entry capacity rights – both function as constraint management tools. Ofgem considers that a constraint could be considered to have occurred where there is

² *Summer Interruptions: 17 and 18 June 2003, Conclusions*, Ofgem, August 2003.

a dislocation between the location of supplies entering onto the system and the location of demand for gas from the system.

More specifically Ofgem considers that buying back entry capacity at a particular terminal, will result in flows being directed by shippers to other terminals where there is a shortage of gas. These actions would have had the same impact as selling gas from the system on the locational OCM where there was an excess of gas and buying on the locational OCM at a location where there was a shortage. Both of these actions could have the impact of resolving a locational deficit or surplus. Whilst Ofgem recognises that due to the co-mingling of flows at entry points, Transco may not always see the reaction it was anticipating, as was seen in the case of Summer Interruptions, the locational OCM and entry capacity buy backs can both be used with similar purposes in mind.

With regards to the respondent's concerns that only locational sells can be used to resolve capacity constraints, we consider that for the constraint to be effectively resolved a locational buy at the location where there was a deficit of gas is also likely to occur, and thus the inclusion of both would be necessary for Transco to be incentivised in respects of the net cost to the system.

In addition to the substitutability outlined above where Transco could buy locational gas at exit points or sell gas at entry points to relieve locational surplus just as it could buy back entry capacity to address such surpluses, Transco could also indirectly address surpluses in one zone by buying locational gas in another zone instead of buying back entry capacity and in doing so redirect gas flows. Under the NTS SO incentive scheme put in place on 01 April 2002, Transco is not currently incentivised with respect to the use of locational actions to resolve location deficits or surpluses. As such Ofgem feels that it is appropriate to include all locational actions, be they sales or buys, so that Transco is incentivised to use the most appropriate tool for resolving locational constraints, both in terms of cost to the community, and in terms of its incentive scheme.

With regards to the practical concerns raised by Transco Ofgem would like to note that a modification was raised by Transco on 12 March 2004 in order to ensure consistency between the Network Code and the proposed changes to Transco's GT Licence identified in the Section 23(3) notice. The workstream report is currently being drafted and will be submitted on 18 April 2004. If accepted the modification will be implemented with effect from 01 April 2004.

Price performance measure

Respondent's views

A further amendment was proposed by both respondents to the calculation of Transco's Price Performance Measure (PPM) contained in Special Condition 28 B Part 2 paragraph 9(f) to clarify the Authority's stated intention that the proposed modifications would take effect from formula year 3 onwards and would not be retrospective.

Ofgem's views

Ofgem considers that the amendment proposed by respondent to clarify that the proposed changes of Transco's Price Performance Measure (PPM) contained in Special Condition 28 B Part 2 paragraph 9(f) were to take effect from formula year 3 better facilitate the Authority's stated intention that the proposed modifications would take effect from 1 April 2004 and would not be retrospective. Ofgem has made the following drafting amendment (the change is emboldened and italicised).

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 ($PPM_{d,t}$) shall be derived from the following formula:

$$\text{In formula year } t \leq 2$$

$$PPM_{d,t} = \frac{1}{2} \times \left(\frac{(TMIBP_{d,t} - TMISP_{d,t})}{SAP_{d,t}} \right) \times 100$$

$$\text{In formula year } t \geq 3$$

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

Exit Capacity Investment incentive

Respondent's views

Both respondents were concerned that Ofgem had not, in the proposed licence modifications, progressed its proposal to remove the requirement for Transco to introduce universal firm NTS exit capacity registration, despite having received the full support of respondents to the February 2004 proposals document.

One respondent requested that the change of policy be fully justified to the industry, and reiterated their belief that Ofgem should now aim to remove this requirement from Transco's licence as soon as possible and commit to a full regulatory impact assessment of any significant reform to the exit capacity arrangements.

The other respondent remarked that Ofgem had introduced the universal firm obligation without the support of the industry. The respondent noted that the industry continues to oppose the concept of universal firm exit arrangements and that justification for the introduction of a universal firm obligation reform remains outstanding and the impact on customers has not yet to been quantified. This respondent stated their belief that Ofgem should seek to remove Transco's obligation in respect of universal firm NTS exit capacity as part of the current proposals to modify Transco's SO incentive scheme.

Transco's views

Transco did not comment upon the decision to modify only its "shallow" incentives in its response to Ofgem.

Ofgem's views

The obligation upon Transco to put in place universal registration of firm exit capacity was put in place, following extensive consultation with interested parties when put in place the necessary modifications to Transco's GT licence to implement the Transco's NTS SO incentive scheme for the period 2002-2007. Under this obligation Transco is required to use reasonable endeavours to introduce arrangements under which all NTS exit load would be deemed firm. Under these arrangements Transco would tender for the level of interruption it requires and over the long term trade off the costs of interruption with investing in the NTS.

Ofgem, in its guidance note which accompanied the March 2004 Section 23 Notice and proposed modifications, stated its decision to split the incentives into shallow and deep incentives and to consult separately upon each. In addition Ofgem indicated that it intended to publish a second consultation document on changes to the deep system operator incentives at a later date, Ofgem is still considering this issue.

Conclusions

Having carefully considered the responses summarised above, the Authority does not consider that any material change is required to the proposed licence modifications. The Authority has concluded that the licence modifications, as amended, can be incorporated under section 23 of the Gas Act.

On 01 April 2004, Transco (as the Licensee) gave its written consent to the licence modifications, as amended. As required under the Gas Act 1986, the Authority also gave notice of the proposed modifications to the Secretary of State for the Department of Trade and Industry, 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 and the modification shall take effect from 1 April 2004.

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Our Ref: JRM/3555/CORRES/964B

1st April 2004

Dear Kyran,

Modification of Transco plc's Gas Transporter Licence pursuant to Section 23 of the Gas Act 1986 and Disapplication Request for the purposes of Special Condition 28B of the Gas Transporter Licence

Reference is made to the notice ("the Notice") given by the Gas and Electricity Markets Authority (the "Authority") on 3 March 2004 pursuant to Section 23 of the Gas Act 1986 (the "Act") that it proposed to modify Special Condition 17, Special Condition 28A, Special Condition 28B(14) and Special Condition 33 of Transco plc's Gas Transporter Licence.

I confirm that, for the purposes of Section 23 of the Act, Transco plc hereby consents to the modification of the Gas Transporter Licence in the manner specified in Annex 1 to the Notice (as subsequently amended by revised drafting agreed between Ofgem and Transco on 31 March 2004) on and with effect from 00:00 hours on 1 April 2004.

For the purposes of sub-paragraphs 3(i) and (ii) of Special Condition 28B, Part 2, paragraph 16 of Transco plc's Gas Transporter Licence (Disapplication of the NTS SO activity revenue restriction) Transco plc hereby delivers to the Authority a Disapplication Request in respect of the existing NTS SO Activity Revenue Restriction provisions set out in Special Condition 28B, Part 2, paragraph 14, sub-paragraphs 7 and 9 of the Transco plc Gas Transporter Licence to the extent that such provisions are amended by the Notice ("the Relevant Provisions").

For the purposes of sub - paragraph 3(iii) of Special Condition 28B, Part 2, paragraph 16 of Transco plc's Gas Transporter Licence, Transco wishes the Authority to agree that the Relevant Provisions will cease to have effect on and from 24:00 hours on 31 March 2004. Please will you provide us with confirmation of the Authority's agreement in this respect.

Yours sincerely

Tim Tutton

Association of Electricity Producers
Comments in respect of Transco's National Transmission System
System Operator Incentives 2004-2007
Licence Modifications – Shallow Incentives

The Association of Electricity Producers welcomes the opportunity to comment on the proposed licence modifications in respect of Transco's system operator incentives. The Association notes that the licence modifications reflect Ofgem's initial proposals and are unchanged from the original proposals.

The Association broadly supports the proposed licence modifications apart from the target level for the entry capacity buy-back incentive and the way in which locational actions are to be incorporated into this incentive. However we are very concerned that Ofgem has not progressed its proposal to remove the requirement for Transco to introduce universal firm NTS exit capacity registration even though this received the full support of respondents. This change of policy in just a few weeks should be fully justified to the industry. We believe that Ofgem should now aim to remove this requirement from Transco's licence as soon as possible and commit to a full regulatory impact assessment of any significant reform to the exit capacity arrangements.

We are disappointed that Ofgem has not undertaken and presented further analysis to justify the £18M target value for the buy back incentive when performance in the last two years has exceeded this level. We are now concerned that Transco will earn revenue from this incentive without further improvement in performance.

In Ofgem's proposals document (February 2004) it reported that in formula year 02/03 locational actions had resulted in a cost of £2.4M although no further information is provided on the breakdown between locational buys and sells and the reasons for such actions. Analysis of the limited information available from Operational Forum meeting minutes makes no mention of the use of locational sells at entry points but reports several instances when locational buys at entry points have been used to encourage gas into the southern part of the system following supply failures. Further locational buy actions were taken during the 'summer interruptions' on 17 and 18 June 2003. In all cases the locational actions at entry were taken to manage regional linepack and it could be argued were related to transportation constraints within the system but they were not related to inadequate capacity and therefore constraints at entry. We therefore believe it is not appropriate to include such actions that relate to the 'location of energy' as part of Transco's entry capacity buy back incentive. We also note that at the time the OCM was being developed the concept of locational gas was considered important as it provided Transco with a locational gas tool that was more likely to result in a change in physical gas flows at a specific point than a title transaction. It was not developed as a capacity management tool.

The Association considers that there is a stronger case for including locational sell actions at entry in the entry capacity buyback incentive as these may well be used in place of buy-backs, although there is no evidence to date of this occurring. However the proposed licence drafting essentially means that Transco can choose

between a buyback (cost to Transco) and a locational sell action (revenue to Transco) when needing to address an entry capacity constraint. In the future one may therefore reasonably expect Transco to take locational sell actions in preference to entry capacity buy backs and thereby enhance its performance under its incentive. We also note that this effectively re-creates the situation at St Fergus in 1998 that led to the reform of the entry capacity arrangements!

The Association also remains concerned over the treatment of the costs and revenues arising from locational actions that either are taken at exit or are taken at entry but are not related to entry capacity constraints, such actions may be taken as the price is more favourable than title gas or to address regional linepack issues.

If the licence as currently drafted is implemented we would expect to see more use of locational sell actions to relieve constraints at entry and we therefore believe that it is inappropriate to include a cost of £2.9M for locational actions in the entry capacity buy-back incentive target, when sell actions may well become more common than buy actions.

Legal drafting

We note the revised drafting provided in Ofgem's letter of 23 March.

We consider the definition of RLSA should include only those locational sell actions that are associated with managing entry capacity, like the definition for ECCC.

We think that PPM needs to be defined separately for years one and two and for years three to five; with and without the $\frac{1}{2}$ respectively to ensure the intent of the change to the residual gas balancing incentive is captured correctly.

Please do not hesitate to contact the Association if you would like to discuss any issues raised in this response further.

Association of Electricity Producers

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Date: 30 March 2004

Dear Kyran

**Transco NTS SO Incentives 2004 – 2007.
Licence Modifications – Shallow Incentives**

Thank you for the opportunity to respond to the proposed licence modifications in respect of Transco's NTS SO incentive scheme 2004 – 2007.

In general, we support the proposed modifications to Transco's day-to-day "shallow" SO incentive. However, we are concerned that the drafting of the modification in respect of the buy-back performance measure is not clear or consistent and may provide for **all** locational actions taken by Transco to be attributed to the entry capacity buy-back incentive. We question whether this is appropriate and whether only those that are made in order to address entry capacity constraint issues should be treated in this way.

Furthermore, we believe a situation may arise whereby a locational action may result in Transco selling gas from the system and *receiving* money rather than bearing a cost. If this situation were to arise, we question whether the inclusion of that revenue in the entry capacity buyback incentive is appropriate or whether it would skew Transco's performance and potentially change Transco's behaviour in respect of managing NTS capacity constraints. For example, it appears that the current drafting would mean that Transco would get "paid" for failing to provide entry capacity, rather than bearing the cost. For the avoidance of doubt, we do believe that if it is more efficient for Transco to take a locational action or either kind (buy or sell) in order to relieve an entry capacity constraint rather than taking an entry buyback action, it should. However, it is also appropriate to ensure that the incentive scheme that accommodates such action does not distort Transco's decisions in this respect.

More substantially, we are very concerned that Ofgem has not progressed the removal of Transco's requirement to introduce universal firm NTS exit capacity registration. In its February proposals document Ofgem set out quite clearly that it proposed to remove this

obligation. However, despite Ofgem reporting unanimous support for its removal Ofgem has not brought forward the necessary licence modifications to do so.

Ofgem introduced the universal firm obligation without the support of the industry. In addition, no cost benefit analysis or regulatory impact assessment had been undertaken to evaluate and justify the reform. At the very least, we would have expected Ofgem to consider the distributional effect of the universal firm exit proposals on the various groups of customers that will be affected by the change to the regime before introducing the obligation.

In our view, the situation has not changed. At the time of writing:

1. The industry continues to oppose the concept of universal firm exit arrangements;
and
2. Justification for the reform remains outstanding and the impact on customers has yet to be quantified.

In addition, Ofgem's policy on this issue remains unclear. Discussions at the former Exit Reform Advisory Group resulted in Ofgem, in effect, concluding that the obligation may be inappropriate in that consideration had not been given to the interactions between NTS and LDZs. Furthermore, in February Ofgem publicly announced its intention to remove the obligation while less than one month later it decides not to.

Over recent months Ofgem has proposed that the reform of the exit regime is one of the "gateway" requirements associated with the arrangements that need to be put in place in the event that NGT sells one or more of its distribution networks. We do not agree that exit reform is "necessary" for a sale and therefore it should not be progressed as part of the DN sale project. Indeed, we believe that if Ofgem continues to pursue exit reform as a "gateway" requirement, it will at the very least significantly jeopardise the timetable for a possible sale.

We therefore believe that Ofgem should seek to remove Transco's obligation in respect of universal firm NTS exit capacity as part of the current proposals to modify Transco's SO incentive scheme.

Finally, on a drafting point, our initial reading of the proposed modifications suggest that there may be errors in the references to formula year 3 in respect of the proposed text for:

- the changes to the definition of BBCPt and ECCCd,t on pages 10 and 12;
- the definition of the terms "TMIBPd,t" and "TMISPD,t" on pages 16 and 17; and
- the term RLOct inserted into the table contained within Special Condition 33 on page 19.

In each case we suggest that where the proposed text refers to "formula year ($t \leq 3$)" the reference should be to "formula year ($t \geq 3$)" and we understand from Ofgem's letter dated 23 March 2004 that these points have now been recognised and addressed.

However we do believe that there is a further drafting point that has not yet been addressed in respect of the changes to the daily residual balancing price performance measure. We see no difference between the proposed definitions for the term “TMIBPd,t” and “TMISPd,t” that have been inserted in respect of formula year three and beyond compared to that which applies to formula years one and two. Furthermore, the formula relating to PPMd,t appears to be the same irrespective of which year is being referred to and we question therefore whether the drafting achieves the removal of the “1/2” from the calculation of PPMd,t for years three and beyond while leaving the reference to “1/2” for years one and two.

I hope that you will find the above comments useful.

Yours sincerely

Rob McDonald
Director of Regulation

Transco National Transmission System –
System Operator incentives 2004-2007 – Licence modifications –
shallow incentives (47/4)

Note by National Grid Transco

This note provides comments on the detail of the Licence drafting rather than on the intent of the changes, since the intent is unchanged from the prior consultation proposals, to which NGT previously responded.

NGT believes that in several areas the proposed amendments do not reflect the intent of the proposed changes as detailed in the explanatory notes in Annex 2 of the document. The following detailed changes are suggested to bring the Licence amendments into line with the apparent intent or to clarify the Licence wording.

Comment on Licence and Network Code Alignment

1. With the proposed Licence modifications, the Licence and Network Code will no longer be aligned since, under the Licence, locational actions will be included within the entry capacity buy-back incentive whilst under the Network Code locational actions are included within the balancing neutrality mechanism. We suggest that this misalignment could be resolved in one of two alternative ways:
 - a. The Network Code could be modified so as to remove locational actions from being handled through the balancing neutrality mechanism and to include them in the capacity neutrality mechanism. Licence changes would also be needed in order to include the costs and revenues associated with locational revenues within the entry capacity buy-back incentive measure and collected revenue. Under this treatment, the allowed revenues associated with locational costs would be recovered in the same manner as other buy-back cost-related revenues i.e. in proportion to Shippers' daily entry capacity holdings. The suggested changes below are on the basis of this treatment.

We believe that it is important for any Network Code modifications to follow the established processes. Given this, it is unlikely that any modification to deliver the arrangements described in the paragraph above will be in place by 1st April 2004 (when the Licence modifications as proposed are due to take effect). As we have previously suggested, this timing issue could be addressed if a “trigger” was inserted within the GT licence amendments to determine the date from which locational actions are to be included within the Entry Capacity buy-back incentive (and the corresponding changes made to the TMISP and TMIBP terms within the Residual Gas Balancing incentive).

- b. Locational actions could be left within the balancing neutrality mechanism. The costs (and revenues) of such actions would still be included within the capacity buy-back performance measure, for comparison against the target. Such a treatment is simpler in terms of the extent of required Licence changes, and has the benefit of not requiring Network Code or supporting billing changes. However, it would leave the net daily cost (or revenue) of locational actions being recovered (or paid) through the balancing neutrality mechanism

and so recovered on a daily throughput basis from Shippers whereas other capacity buy-back costs would be recovered on an entry capacity-holding basis.

Special Condition 28A: Revenue restriction definitions

2. Locational buy actions and locational sell actions are referred to in the Paragraph 7 amendments. For clarity, we suggest that definitions of these terms are added into Special Condition 28A along the lines of:

Locational buy action means any locational action resulting in the buying of gas. Locational buy actions will be treated as generating a cost to the licensee.

Locational sell action means any locational action resulting in the selling of gas. Locational sell actions will be treated as generating a revenue for the licensee.

3. We suggest that in the definition of locational actions the references to NGT are replaced by “the licensee”. The final sentence of the definition should be deleted and replaced by the above new definitions.

Additional amendment to Special Condition 28B Part 2 13(3) – Associated SO charges (SOROC_t)

4. In order to account correctly for the revenues from the locational actions, the term RLOC_t needs to be added to the term SOROC_t from t ≥ 3. The following changes to the Licence are suggested:-

In formula year (t ≤ 2)

$$SOROC_t = RNC_t + RCOR_t + FTI_t$$

In formula year (t ≥ 3)

$$SOROC_t = RNC_t + RCOR_t + FTI_t + RLOC_t$$

Special Condition 28B Part 2 13

Paragraph (7)(b) – Entry Capacity buy-back incentive

5. The second formula for BBCP_t should be for t ≥ 3 rather than t ≤ 3.
6. The second formula for ECCCD_t should be for t ≥ 3 rather than t ≤ 3.

Paragraph (8)(c) – System balancing incentive

7. The wording for SRCP_t would be improved were the word “for” inserted as follows:

“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 for or gas delivery ...”

Paragraph (9)(f) – Residual gas balancing incentive

8. The second definition for $TMIBP_{d,t}$ should be for $t \geq 3$ rather than $t \leq 3$ and should have the clause “**excluding any locational actions**” inserted after the second occurrence of “(having the meaning given to that term in the licensee’s Network Code)”.
9. The first definition for $TMISP_{d,t}$ should be for the “**lowest**” market offer price.
10. The second definition for $TMISP_{d,t}$ should be for the “**lowest**” market offer price and should apply for $t \geq 3$ rather than $t \leq 3$.

Amendment to Special Condition 33

11. The date for the reporting to apply for both $RLOC_t$ revenue and the volumes, locations and prices of locational trades should be for $t \geq 3$ rather than $t \leq 3$.
12. The daily information to be provided relating to $RLOC_t$ should refer to “locational actions” rather than “locational trades”.