

## Appendix 1

### **Transco contracting direct with consumers and The Gas Act 1995 (as amended)**

*This appendix note gives some background information on the debate that has occurred over the past few years regarding the issue of whether Transco can contract directly with consumers under the provisions of the Gas Act. This note is not intended to be complete but to give an indication of the debate to date. All RGTA meeting notes, Ofgem /ERAG meeting notes and Ofgem documents are available on the relevant websites.*

In 1999, Ofgas published a document outlining issues arising regarding competition in the non-domestic sector of the market. Amongst the issues discussed was whether there should be connection agreements in gas as there were in the electricity market. In this document, Ofgas noted that there could be issues with the Gas Act if contracting between Transco and consumers was introduced. .

*[SGD has archived this document but it should be available in Ofgem's library.]*

In March 2001, Ofgem published its proposals for changing the interruptions regime. Many respondents to Ofgem's March 2001 consultation document raised the issue of problems arising due to the wording of the Gas Act.

Ofgem did not publish a conclusions document in respect of the interruptions regime, but did set out its views on the way forward in its September 2001 document on the SO incentives regime. This document did not address the issues raised concerning the Gas Act restrictions.

On 20 September 2001, following the publication of Ofgem's SO Incentives document, a seminar was held to discuss its contents. During this seminar, Ofgem was requested to provide information on how the Gas Act issue would be addressed. Ofgem suggested that it would be up to the industry to find ways to contract in keeping with the Gas Act. *[SGD notes of this meeting]*

At the December 2001 RGTA workstream, a number of issues listed that would need to be addressed in order to implement Ofgem's proposals to reform the exit arrangements. One of the issues identified was "Gas Act (Transco & End User contracting)".

Ofgem published its section 23 notice to amend Transco's licence for its 2002-07 price control in August 2002. In response to this, SGD requested again that Ofgem state "whether it considers that the Gas Act will need amendment in order for these proposals to be implemented (and if it does not, why not)".

Ofgem's letter of 27 September 2002 issued when Ofgem consented to modify Transco's licence for its 2002-07 price control stated that Ofgem "recognises that any proposed reforms must be consistent with Transco's wider obligations under the Gas Act 1986 and other statutory instruments such as the Gas Safety (Management) Regulations 1996."

The 30 October 2002 RGTA workstream considered again the list of issues to be addressed (from the December 2001 workstream). This list still included the Gas Act issue.

Minutes 12 December 2002 RGTA meeting: "Transco / End User Contracting: Transco advised that the service being offered must be clear particularly in relation to whether the Gas Act allowed Transco to enter into contract with gas consumers. It was suggested by one representative that Ofgem and Transco should come to a common understanding of whether the Gas Act allowed such contracting between a gas transporter and end consumer, and that the DTI had previously advised it would expect any issue of the possible need for exemption

be brought to its attention by Ofgem. An attendee noted that it was fruitless to discuss this issue without understanding whether contracts between parties were possible. Transco advised that it would look to obtain guidance on process and timeline in order to move this issue forward.”

Minutes of Exit Reform Advisory Group, 17 January 2003: “Ownership of capacity rights and providers of interruption. The group discussed whether it was possible under the existing regulatory framework for Transco to contract directly with end users. Transco explained that its provisional legal view was that under the current regulatory framework it can only make arrangements for interruption at exit points with market participants that hold shipper licences. Transco also explained that to enter into such arrangements with end users it may need a Gas Transporter’s licence exemption under the Gas Act that the Secretary of State would need to grant by Statutory Instrument. Transco stated that there may be other legal solutions to allowing it to contract directly with customers. However, it preferred the exemption solution as this approach was less open to challenge. Transco agreed to set out the problem and its views on the issue in writing for the ERAG to consider. It was agreed that Ofgem and Transco lawyers will meet to discuss the issue next week both in terms of an exemption and other arrangements that could be made to facilitate end user interruption contracts.”

Minutes of Exit Workstream 27 February 2003: “Gas Act: Transco stated the issue as one of whether the Gas Act required Transco to solely contract with Shippers for the provision of gas transportation services. Transco advised that the DTI would expect Ofgem to request any exemption to the Gas Act and that this process could take between 6 to 9 months to complete. It was recognised at ERAG that the respective legal teams of Transco and Ofgem would meet to discuss and agree whether an exemption to the Act was required in order for Transco to contract for services with non shippers.”

Minutes of Exit Workstream 24 March 2003: “2.2 Discussion had identified the need, or not, for a Gas Act exemption as the critical path item, Ofgem and Transco confirmed that their respective lawyers would meet shortly to reach a common understanding.”

Minutes of Exit Workstream 10 April 2003: “The workstream urged Transco and Ofgem to formally clarify the legal status of whether a Gas Act exemption was required in order for Transco to enter into turndown contract with a gas consumer.”

Minutes of Exit Workstream 29 April 2003: “4. An attendee requested an update on discussion between Transco and Ofgem relating to any requirement for Gas Act exemption where turndown contracts are entered into between Transco and consumers. Transco advised that the respective legal teams from Ofgem and Transco had yet to meet, adding that it hoped this would occur in early May.”

In May 2003, Ofgem wrote to the industry stating that further work on exit arrangements would be taking forward exit regime reform as part of the DN Sale project.

Ofgem’s December 2003 document on the DN Sale also discussed this issue: “5.24: An issue that was raised by respondents in the consultation process relates to whether customers are able to contract with Transco for the provision of interruption to Transco. 5.25. Ofgem has concluded that it is possible for a customer to enter into contracts with Transco by which the customer agrees to turn down its consumption of gas without breaching section 5 of the Gas Act.” However, we understand that Transco has expressed concern that this is insufficient to allow it to enter into contracts with customers for capacity and/or interruptions contracts.

*As we have set out in our response to this document, we are not convinced that there is anything that shippers or consumers can do in workgroups to further resolve this issue.*

## Appendix 2

### Cross-subsidies

*This note sets out some of the issues regarding whether there is a cross-subsidy between firm and interruptible consumers. Ofgem's interruptions document appears to assume that interruptibles are being cross-subsidised by firm customers. However, no analysis has been provided to support this view. This note is based on information previously submitted to ERAG by an industry group with additional material added.*

#### Cross subsidies between firm and interruptible customers

*What costs do firm customers impose on the system?*

- Transco NTS has a licence obligation to invest to meet 1 in 20 peak day demand for firm customers. It is also required to make sure that its charges reflect the cost incurred.
- Therefore if all investment is related to meeting peak demand, TO capacity charges should relate to peak capacity, to levy charges in any other way would not be cost reflective.
- Any system operation costs arising from providing capacity or transporting gas to firm sites should be collected through SO charges

*What costs do interruptible customers impose on the system?*

- Transco has not made any investment for interruptible sites and they are not expected to be using capacity at peak
- Therefore, it is cost-reflective for interruptible sites to not pay TO capacity charges.
- Any system operation costs arising from transporting gas to interruptible sites should be collected through SO charges

As long as the SO commodity charge properly reflects that the marginal costs incurred by NGT of transporting the extra gas, then there is no cross-subsidy from interruptible to firm customers. However, there may be a cross subsidy from interruptible to firm customers arising from SO charges not being consistent with a cost reflective capacity : commodity split, ie interruptible customers pay more than the extra cost to Transco of moving their gas around. Analysis provided by Transco in 1998 at an industry forum showed that the split should be around 90 : 10. The current split on the NTS is 78 : 22 which, based on analysis provided, supports the theory that NTS interruptibles are cross-subsidising others.

This analysis may not hold entirely for all DN customers as Transco may build capacity to supply interruptible customers and the capacity : commodity split differs. However, there are still concerns about whether the capacity : commodity split on the DNs is correct and whether the charges are fully cross-reflective. This is the subject of Ofgem's June document on LDZ charges. We would expect that analysis would be done to see whether there are cross-subsidies, their extent and direction before solutions are put in place .

#### 2. Cross subsidies between interruptible customers

Cross subsidies are thought to exist between interruptible customers, since they all receive the same discount (exemption from exit charges) but provide Transco with different levels of service.

- In a mild winter Transco interrupts sites for different numbers of days, depending on system conditions, constraints etc. It is not incentivised to minimise the number of times it interrupts a site until the day count exceeds 15, when payments per interruption are triggered.
- In a severe winter Transco would need to interrupt all sites simultaneously for 15 days and interruption would be required on 60 other days. (presentation to workstream on 14 October 2003)

So it would seem that Transco has currently contracted for the 'correct' volume of interruption at peak but for some sites has contracted for more days (45) than it actually needs.

As far as we are aware, there is no cross subsidy between interruptible customers, except to the extent that exit charges foregone are not cost reflective. Indeed, if there is a very cold winter, and customers are interrupted for more 45 days, they will end up paying a negative transportation charge. This is not an argument for wholesale reform of the interruptions regime but to suggest that the level of rebate needs to be reconsidered.

### **3. Other comments**

From experience with the entry capacity auctions, we know that there is on-going conflict between an approach which determines the 'value' of the monopoly pipeline assets. Recent problems have arisen as re-allocation of under-recovery in a manner that meets the requirements of Transco's obligations under its licence but which also remains consistent with Ofgem's previous approach to over-recovery based on the principles it outlined at that time. As long as Transco is required to charge for exit capacity in a cost reflective way and has its revenue price controlled (we would be concerned if these were to change), the current regime remains the most efficient and economic approach to charging for exit capacity.

In SGD's appendix 2, we outline a series of requests made by the industry to Ofgem to resolve the issue of the perceived conflicts between Transco contracting direct with customers and the provisions of the Gas Act. A similar exercise could be carried out in relation to industry requests for Ofgem analysis on cross-subsidies. Over the past few years, Ofgem has committed to providing analysis requested by the industry, often suggesting it would be made available in upcoming documents, the most recent of these being the initial NGT DN Sale document in July 2003. At the January 2004 exit workstream, Ofgem was reminded of the industry's "earlier requests that they (Ofgem) provide information on the level of interruption and an indication of the level of cross subsidy between firm & interruptible Users" (minutes 14 January 2004). Ofgem's recent document setting out its review of DN charging structure provides no indication that interruptible consumers are being cross-subsidised. We are disappointed that the interruptions arrangements document does not provide detailed analysis on this issue.