

URGENT Modification Report
Volume based test for Summer 2002 Entry Capacity
Modification Reference Number 0530

Version 4.0

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.9.3.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because The Summer 2002 Entry Capacity Auctions are due to commence on the 15 February 2002. Ofgem has decided that urgent procedures are necessary due to the short period of time remaining before the commencement of these auctions.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

Issued to Ofgem for decision on urgency	31 January 2002
Proposal agreed as urgent	31 January 2002
Proposal issued for consultation	1 February 2002
Close out for representations	6 February 2002
Final report to Ofgem	8 February 2002
Ofgem decision expected	8 February 2002

1. The Modification Proposal

The proposal is as follows:

- A preliminary allocation round is included immediately before the pay-as-bid auction process;
- Users will be required to submit to Transco their volume requirements per ASEP per month;
- In the event that the aggregate of the volume requirements per ASEP per month is less than the published Baseline Capacities, then capacity will be released by Transco to match the Users requirements. All entry capacity would be sold at the reserve price, and the further rounds of the auction process will not be held;
- In the event that at any ASEP in any month the aggregate volume bid per ASEP exceeds the Baseline Capacity then the auction process will continue for all ASEPs for the months in which the Baseline Capacity is exceeded.

2. Transco's Opinion

Transco observes that the intention of the Modification Proposal is to reduce the risk of revenue over-recovery from the forthcoming MSEC auctions thus providing greater clarity to Users about the product being offered for sale.

Transco recognises the uncertainty associated with potential over-recovery in the MSEC auctions and that the requirement to redistribute any such excess monies creates risks for Users. However it is important to

acknowledge that any outcome arising should this proposal be implemented would be possible under the current arrangements. Therefore if this proposal were to lead to an efficient outcome then such outcome is not precluded by the current process.

Transco also observes that the Modification Proposal aims to provide efficiency in the auction process. Transco recognises that the proposal may afford some benefits to Users for months where the current auction processes would not need to be enacted. However Transco believes that such benefits may be offset by the additional risk arising from the manual work arounds and processes that this proposal would require, particularly in mind of the short timescales proposed.

Transco welcomes the high level of response to this modification proposal, which reflects its potential importance to the industry. Transco notes, however, the differing views about the potential impacts of implementing the proposal, both in terms of increasing risk and uncertainty, and in terms of the likely impact on the level of revenue recovery.

Given the differing views expressed, Transco believes there would be merit in further discussion of the proposal with a view to establishing a better understanding of the way in which the proposal might be expected to operate in practice. However, the present auction timetable does not allow sufficient time for this to be achieved, and , therefore, Transco does not support implementation of the proposal at this time.

3. Extent to which the proposed modification would better facilitate the relevant objectives

The Proposer does not explicitly state how the Proposal would better facilitate the relevant objectives, although it does argue that the Proposal, if implemented, would provide efficiency in the auction process.

4. The implications for Transco of implementing the Modification Proposal , including
a) implications for the operation of the System:

The Proposal would introduce significant implications in respect of the operation of the MSEC auction process within the RGTA Capacity system. Transco has concerns in respect of the significant and complex manual work arounds that would be necessary to accommodate, within the proposed timescales, the implementation of this Modification Proposal prior to the commencement of the summer entry capacity auctions.

b) development and capital cost and operating cost implications:

Transco anticipates that it would be subject to a modest increase in operating costs as a result of implementation of this proposal, although a full impact assessment has not been possible within the limited timescales.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

The additional operating costs would be met from allowed revenues for such purposes.

d) analysis of the consequences (if any) this proposal would have on price regulation:

Transco does not anticipate any such consequences as any potential under or over recovery will be managed within Transco's allowed revenue mechanism.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

Transco does not anticipate any such consequences.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

The modification proposal may have development implications regarding how Transco may communicate information to Users relevant to the proposed volume based auction.

7. The implications of implementing the Modification Proposal for Users

The modification proposal may require Users to re-consider their bidding strategies.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

Transco does not anticipate any such implications.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

Transco does not anticipate any such implications.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages:-

- May reduce the likelihood of over-recovery.
- May increase efficiency in the auction process by reducing the number of auctions
- May provide greater certainty to Users regarding the product for sale.

Disadvantage:-

- Timescales for such complex manual developments are challenging.
- May further delay the forthcoming MSEC auctions.
- Increases risk of error during manual processes for both the User and Transco
- Manual processes may increase complexity and costs for both Transco and Users.
- Timescales for Users to revise their bid strategies will be very short.
- May reduce the likelihood of the emergence of efficient pricing signals
- May increase the number of tranches in the Auction.

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representations have been received from the following eighteen parties :

AGIP (UK) Ltd	AGIP
BG Group	BG
British Gas Trading	BGT
BP Gas Marketing Ltd	BP
Chevron Texaco	CT
Conoco	Co
ExxonMobil Gas Marketing	Exxon
Innogy	In
London Electricity	LE
Marathan Oil	MO
Norsk Hydro (UK) Ltd	NH
Phillips Petroleum	PP
Scottish & Southern Energy	SSE
Shell Gas Direct Ltd	SGD
Statoil (UK) Ltd	STUK
TXU Europe Energy trading Ltd	TXU
TotalFinaElf Gas & Power Ltd	TFE(G&P)
TotalFinaElf Exploration	TFE (Expl)

Of these, ten respondents express support for the modification proposal while eight do not support the modification proposal.

General

Of those respondents expressing support for the proposal, a frequently expressed view is that its introduction would increase certainty to the product for sale and the auction process. In particular, SSE observes that the primary reason for raising the urgent proposal is that there remains a considerable amount of uncertainty with regard to the treatment of any potential over/under-recovery and the proposed buy-back arrangements. It further adds that this uncertainty would therefore feed into the "value" that shippers place on capacity.

CT believes that there is a misalignment between the product offered in the forthcoming auctions and the regulatory regime that will be applied to entry capacity for April - September 2002 and that the proposal offers a way in which the risk of this gap adversely impacting shippers can be minimised. TFE (Expl) comments on the lack of consistency in the timing of licence change proposals with respect to the auctions.

A number of parties in support of the modification proposal argue that the modification proposal would reduce the likelihood of over-recovery and increase the efficiency of the auction process. PP comments that the proposal has advantages in that it mitigates the risk of all months being subject to "pay as bid" processes.

Although AGIP expresses support for the proposal, it does not agree that where bids at an ASEP in a month exceed the baseline capacity offered that the auction process should remain open for all ASEPs.

Of those respondents who do not support the modification proposal, two respondents (Inn,SSE) comment on Ofgem's confirmation that any licence amendments will not be implemented from 1 October 2002 and therefore that the existing arrangements in respect of buy-back and over/under-recovery will continue. BGT states that it is supportive of the principles of the modification proposal, but it has a number of reservations on the implementation of the modification at this time. SSE comments that it is supportive in principle to a volume based allocation at the reserve price.

Over/Under-recovery and Effects on Capacity Prices

Four respondents (Exxon,TFE(G&P),PP,AGIP) suggest that the modification proposal would reduce the likelihood of over-recovery.

Three respondents (BG,SSE,BGT) argue, however, that there remains the possibility of over-recovery with implementation of the modification proposal. BG comments that the modification may prevent a modest over-recovery but that a concern would be that the modification would focus from the outset more aggressive bidding behaviour where there is this perceived constraint for volume at the reserve price. BG argues that there is likely to be even greater over-recovery. SSE comments that as this is the first time that Transco will be selling baseline capacity over the summer it is difficult to predict the outcome of any over/under-recovery. SSE and BGT argue that previous experience of summer entry capacity auctions would suggest that it is still possible that there could be an over-recovery, especially if there is high demand for St Fergus entry capacity.

LE observes that given that reserve prices are based on 75% of LRMC prices there is a risk of under-recovery.

SSE provides further comments on the treatment of revenue from the proposed volume based auction and any further sale of remaining capacity as "off-the-shelf". It queries how revenue from the daily auctions will be treated and observes that this will need to be resolved to remove uncertainty about the impact the sale of entry capacity will have on transportation charges.

LE argue that publishing baseline quantities prior to any auction may have an adverse effect of pushing up prices at specific ASEPs where the baseline quantities have been breached. PP suggests that the proposed preliminary allocation round will provide an incentive on shippers to not demand quantities of reserve-priced capacity in excess of their requirements since it is likely to lead to an auction process with resulting prices very likely to be higher than the reserve price. TXU argues that the proposed volume auction could increase prices at terminals where bids have exceeded the baseline capacity by creating the impression of a shortage of capacity.

BG suggests that the modification encourages demand for capacity at a scaled reserve price which would tend to exaggerate demand and increase buy-back requirements. Conoco expresses concerns that if demand for capacity exceeds supply Transco will be running a four round auction at all ASEPs only for months that are constrained. It suggests that this may exaggerate the problems seen in last summer's auction where the Industry found that shippers bid for greater volumes at much higher prices.

Administrative Complexity/Efficiency of Auction process

Five respondents (AGIP,CT,Exxon,SGD,TFE(G&P)) comment that the modification proposal would provide efficiency to the auction process and reduce the administrative burden by removing auction rounds where they are unnecessary. Exxon and TFE(G&P) also suggest that bids could be entered on RGTA as if it were Round 1 of five and shippers would enter their capacity requirements at the reserve price.

Innogy suggests that implementing the modification proposal would require manual work rounds that would add significant risks.

Timescales

STUK argues that the introduction of a modification at this stage does not allow enough time prior to the auctions. STUK also argues that the industry needs time to accurately assess the impact that such a change may have on the results of the auction. BGT and SGD express concern that the modification has been raised close to the commencement of the auction period.

SSE considers that shippers need a minimum of two business days between the volume based auction and the start of the subsequent price auctions. It suggests that the latest date the volume based auction could happen would be Tuesday 12 February. STUK observes that it is also the case that any volume bids may have to be submitted manually and the results may not be issued until the day before the price-based auction could commence. It suggests that this would impose unacceptably short lead times on shippers participating in the auctions. Innogy expresses preference for minimising changes to the auction rules and format and argue for the framework and timetable set out in Transco's "Invitation to Participate" to be retained.

TFE(G&P) accepts that following Ofgem's approval of Modification 0499 (Transition Arrangements for the Long Term Capacity Allocation) , whilst "challenging" , there would be sufficient time to include the initial volume round in the auction process and for Transco to report back with the outcome.

Other Points

BG argues for the introduction of an additional charge for unutilised capacity, over and above any buy-back costs that are smeared against MSEC holders, in the event that the modification is introduced. It comments that this would be intended to reduce the potential for hoarding of capacity.

BGT observes that with the modification proposing that in the event that a single ASEP exceeds its baseline quantities in any particular month then no ASEPs would close out for that month, it is likely that few, if any, months will close out from this single preliminary round.

Exxon argues that under the proposal the risk of "wrecking" bids to force an auction process cannot be eliminated. It suggests that to help minimise the consequential effects of any such actions, Transco should publish aggregate demand at each ASEP for all months, including those that did not clear.

SSE and SGD query, where an ASEP is over-subscribed following the proposed volume based auction, the information that Transco would release to the market prior to initiating an auction. SSE express concerns

that were Transco to issue details of the extent of demand over the baseline volume, this could "spook" the price auction, escalate prices and possibly result in an over-recovery situation.

Transco's Response

Transco welcomes the clarity provided by Ofgem in its letter of 6 February 2002 which describes the arrangements that will apply to revenue flows for the summer of 2002.

Transco welcomes the high level response to this modification proposal, which reflects its potential importance to the industry. Transco notes, however, the differing views about the potential impacts of implementing the proposal, both in terms of increasing risk and uncertainty, and in terms of the likely impact on the level of revenue recovery.

Given the differing views expressed, Transco believes there would be merit in further discussion of the proposal with a view to establishing a better understanding of the way in which the proposal might be expected to operate in practice. However, the present auction timetable does not allow sufficient time for this to be achieved, and , therefore, Transco does not support implementation of the proposal at this time.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Transco does not anticipate any such requirements.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Transco does not anticipate any such requirements.

14. Programme of works required as a consequence of implementing the Modification Proposal

No changes to the UK Link systems are anticipated and therefore a program of works would not be required.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Ofgem decision 8 February 2002
Implementation 15 February 2002

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of the Modification Proposal.

17. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This Modification Report contains Transco's proposal not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date:

Gas and Electricity Markets Authority Response:

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0530**, version **4.0** dated **08/02/2002**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **4.0**.

Signature:

Process Manager - Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:
 - (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or
 - (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

provided that if the Authority does not so approve the Agreement then Clause 3 shall apply.
2. If the Authority does so approve this Agreement in accordance with the terms of the Order (whether such approval is actual or deemed by effluxion of time) any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.
3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, had it not been repealed, would apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) or 2(2)(b)(ii) of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.
4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.