

**Modification Report**  
**Removal of Energy Balancing Incentives from the Network Code**  
**Modification Reference Number 0519**  
Version 2.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

## **1. The Modification Proposal**

If implemented, this Modification Proposal would remove existing provisions that relate to Transco's energy balancing incentive from the Network Code. Transco's energy balancing incentive would instead be defined in its Gas Transporters (GT) Licence.

It would be necessary to coordinate the implementation of this Modification Proposal with any relevant amendments to Transco's GT Licence to help to ensure that no conflict arises between the provisions of the Network Code and Transco's GT Licence.

## **2. Transco's Opinion**

Transco believes this Modification Proposal is required to facilitate Ofgem's proposals to revise the governance structure of Transco's NTS SO incentives. Ofgem's proposals would result in the definition of Transco's incentives, incentive parameters and provisions for the calculation of incentive amounts being contained within Transco's GT Licence.

Transco believes this Modification Proposal would facilitate Ofgem's proposals by enabling the migration of Transco's energy balancing incentive scheme from the Network Code into its GT Licence. This migration would result in the NTS SO energy balancing incentive being defined through Transco's GT Licence and included as part of the calculation of Transco's NTS SO allowed revenue.

Transco believes that failure to implement this Modification Proposal might lead to inconsistency, duplication and conflict between the provisions of the Network Code and the proposed Transco GT Licence conditions.

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

In the event that Transco's energy balancing incentives are incorporated into Transco's GT Licence, Transco believes that it would be necessary to remove the existing provisions that relate to energy balancing incentives from the Network Code to mitigate the risk of a conflict arising between the terms of the Network Code and Transco's GT Licence.

Therefore, Transco believes that implementation of this Modification Proposal would better facilitate adherence to the relevant objective contained in Standard Condition 9 of its GT Licence, i.e. the efficient discharge of Transco's obligations under its GT Licence.

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

Transco is not aware of any implications for the operation of the System.

**b) development and capital cost and operating cost implications:**

Transco is not aware of any development, capital or operating cost implications that would arise from the implementation of this Modification Proposal.

**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:**

Not applicable.

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

This Modification Proposal does not propose any changes to Transco's allowed revenue or the way in which it is recovered.

**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**

The effect of this Modification Proposal would be to marginally reduce Transco's contractual risk under the Network Code through the removal of the energy balancing incentive scheme. However, it is envisaged that this affect would be offset by the inclusion of Transco's energy balancing incentive scheme in Transco's GT Licence.

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

Transco's computer systems would be unaffected if this Modification Proposal is implemented. Transco is unaware of any impact upon Users' systems.

**7. The implications of implementing the Modification Proposal for Users**

If this Modification Proposal is implemented Users would no longer receive ad-hoc invoices in respect of energy balancing incentive amounts.

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

Transco is unaware of 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**

The contractual obligations faced by Transco and Users in relation to Transco's energy balancing incentive would cease to be defined by the Network Code.

The regulatory obligations which would arise from potential amendments to Transco's GT Licence are not the subject of this Modification Proposal.

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

The advantages of implementing this Modification Proposal are:

- facilitating the implementation of Ofgem's proposed governance structure;
- prevention of a conflict of terms between the Network Code and Transco's GT Licence in respect of Transco's NTS SO incentive schemes;
- facilitation of an appropriate governance structure and a stable regulatory regime within which Transco may respond to its incentives.

The stated advantages are consistent with Ofgem's view that "...those aspects of the new incentive arrangements that have the potential to materially affect Transco's financial position should be included in its licence. We consider that this is necessary to provide Transco with a sufficient degree of certainty in order to allow it to respond to its incentives.". (paragraph 11.6: Transco's NTS SO incentives 2002-07, Final Proposals).

The disadvantage of this Modification Proposal is that the Network Code may be considered to be more flexible than Transco's GT Licence in respect of the ease with which it may be amended to respond to regime changes. However, Ofgem has adopted the view that this disadvantage is offset by the need to balance "...the flexibility offered by the Code against the need for stability and certainty." in determining the appropriate governance structure for Transco's incentives. (paragraph 11.5: Transco's NTS SO incentives 2002-7, Final Proposals).

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

The following Shippers submitted representations in respect of this Modification Proposal:

<b>Shipper</b>	<b>Shipper Reference</b>
Scottish and Southern Energy Plc	SSE
Powergen	PWG
Total Fina Elf	TFE
BP Gas, Power and Renewables	BP
BG Gas Services Limited	BGGS
STATOIL	STUK
British Gas Trading	BGT
Agip (UK) Ltd	Agip (UK)
Shell Gas Direct Limited	SGD
TXU Europe Energy Trading Limited	TXU
Dynegy UK Ltd	Dynegy

The table below provides a summary of the representations made by Shippers:

Shipper Reference	Support for Proposal		Summary of comments
	Yes	No	
SSE		✗	<p>* Generally supportive of Transco's incentives being migrated to its GT Licence;</p> <p>* Unable to comment meaningfully on this proposal in absence of the GT Licence drafting for the proposed Transco NTS SO incentives;</p> <p>* It would be appropriate for there to be a concurrent consultation in relation to the GT Licence framework and the proposed Network Code (NC) changes;</p> <p>* There is inconsistency between the draft legal text submitted to the December Modification Panel and the draft legal text which accompanied the Draft Modification Report.</p>
PWG		✗	<p>* There may be justification for placing Transco's financial incentives in the NC;</p> <p>* There should be full industry as well as Ofgem supervision of incentive schemes given that participants fund the gas regime;</p> <p>* Defining Transco's operational incentives in the NC provides market participants with the opportunity to amend incentive parameters in response to changing market conditions;</p> <p>* In July 1999 Ofgem agreed with Shippers that defining incentive mechanisms under the NC "better facilitates refinements to the auction rules and incentive mechanisms if necessary when we have some experience of their operation".</p>
TFE		✗	<p>* Due to ongoing reforms to the energy regime there may be a need to amend Transco's energy incentive arrangements;</p> <p>* Regime changes could result in contractual and potentially significant financial impacts upon Shippers and Transco;</p> <p>* TFE are uncomfortable with the NC being amended to accommodate the introduction of Transco's NTS SO incentives into Transco's GT Licence where the proposed GT Licence conditions have not been drafted, consulted upon or accepted by Transco and all parties;</p> <p>* Migrating Transco's energy balancing incentives into the GT Licence would remove the contractual and economic safeguards and influence that is afforded to Shippers by the NC modification process.</p>
BP		✗	<p>* Until the outcome of Review Proposal 0513 is known it is inappropriate to consider removing the energy balancing incentives from the NC;</p> <p>* Consideration of migrating Transco's incentives from the NC into Transco's GT Licence is appropriate to avoid potential duplication and conflict between the provisions of the two documents once the energy balancing regime has been reviewed and the GT Licence amendments have been finalised.</p>
BGGS		✗	<p>* This Modification Proposal is inevitable;</p> <p>* This Modification Proposal may improve the stability of Transco's incentives;</p>

## Network Code Development

		<ul style="list-style-type: none"> <li>* There is concern that the proposal would be detrimental given that the energy and capacity regimes are under review and the proposal removes Shipper influence on the direction of the industry's development in this area;</li> <li>* Concerned that the energy balancing regime is sufficiently in limbo to make this proposal a detrimental move. This proposal is premature.</li> </ul>
STUK	✓	<ul style="list-style-type: none"> <li>* This proposal is an essential part of the new SO incentives and to ensure consistency between Transco's GT Licence and the NC;</li> <li>* Supportive of placing as many elements as possible into Transco's GT Licence rather than the NC in order to reduce the level of regulatory uncertainty faced by the industry.</li> </ul>
BGT	✓	<ul style="list-style-type: none"> <li>* Qualified support offered for implementation of the Modification Proposal as inclusion of Transco's incentives within the GT Licence conditions has the benefit of affording Transco greater certainty;</li> <li>* Prior to implementation of the proposal there needs to be greater certainty as to the structure of the regime and interaction with the incentives;</li> <li>* If the proposed incentives have industry wide support they should be included within Transco's GT Licence;</li> <li>* Previous experience of incentives has shown that there may be a need to further amend the incentives;</li> <li>* A consultation on the proposed GT Licence conditions is expected in February 2002 and the removal of incentives from the NC must be coordinated with the debate on the GT Licence conditions.</li> </ul>
Agip (UK)	✗	<ul style="list-style-type: none"> <li>* SO energy balancing and energy balancing incentives should be retained within the NC rather than being migrated to Transco's GT Licence;</li> <li>* Including the incentives in the NC allows Shippers to challenge them and to propose amendments through the modification process and this is appropriate given that Ofgem's proposed incentives are new and untested.</li> </ul>
SGD	✗	<ul style="list-style-type: none"> <li>* This proposal removes the potential for Shippers to propose changes to Transco's incentives through the NC modification process. If implemented, the proposal would substantially reduce Shippers' ability to challenge decisions which have a direct financial impact on them;</li> <li>* Only Ofgem can propose changes to Transco's GT Licence;</li> <li>* The affect of the proposal would be to reposition Ofgem's role in the contractual arrangements between Transco and Shippers by increasing the role of the regulator with respect to sliding scale incentives;</li> <li>* Transco's incentives which relate to its behaviour in the market can have major financial impacts on Shippers and giving responsibility to Ofgem for this would not improve the efficient operation of the pipeline;</li> <li>* Experience with incentives to date does not give confidence that Ofgem is always able to</li> </ul>

		judge fully the impact of the incentives;
		<ul style="list-style-type: none"> <li>* The inability of Shippers to propose modifications to rules that impact the market must have a detrimental affect on the efficient operation of the pipeline system and may undermine effective competition between Shippers.</li> <li>* While Transco has the option of referring any GT Licence changes to the Competition Commission, it is our understanding that Shippers will not have the same ability to make such a reference.</li> </ul>
TXU	×	<ul style="list-style-type: none"> <li>* It is difficult to support the Modification Proposal as there has not been any indication of what the GT Licence conditions will contain as they have not been issued for consultation yet.</li> <li>* Migrating the incentives from the NC into Transco's GT Licence will remove Shippers ability to propose amendments to the incentives and will subsequently undermine the contract between Shippers and Transco.</li> </ul>
Dynegy	×	<ul style="list-style-type: none"> <li>* The Modification Proposal should not be raised prior to Shippers having seen and having had the chance to comment on any change to Transco's GT Licence;</li> <li>* Changes to the NC should reflect current GT Licence obligations including the relevant objectives;</li> <li>* Incentives are better defined in the NC given that both Shippers and Transco are able to effect a change proposal. Removing the obligation from the NC would mean that only Ofgem and Transco could raise an amendment.</li> <li>* It is possible to achieve a stable regulatory regime with the non-implementation of this Modification Proposal especially given Ofgem's role in the change process for Modification Proposals.</li> </ul>

Transco welcomes the general support for the principle of migrating its incentives from the Network Code into its GT Licence.

Transco's maximum allowed revenue is appropriately defined within its GT Licence and there are no proposals for this governance structure to be amended. Under Ofgem's proposals for Transco's NTS SO incentives 2002-2007, Transco's NTS SO incentive performance will form part of the calculation of its allowed revenue. Transco believes that, for the purpose of clarity, certainty and consistency it is appropriate for the full definition of its NTS SO allowed revenue to be contained within its GT Licence.

Transco acknowledges that views have been sought on the removal of Transco's energy balancing incentive provisions from the Network Code prior to the detail of Transco's future NTS SO incentives being finalised. However, Transco notes that all parties have had opportunities to fully consider and submit representations in respect of the form, scope and duration of the proposed incentives as part of Ofgem's consultation process.

Several respondents argue that whilst Transco's incentives are contained within the Network Code, Users are afforded the opportunity to amend the incentive parameters in response to

changing market conditions. Some respondents also suggest that removing Transco's incentives from the Network Code would undermine the basis of the contract. Transco recognises that the Network Code modification process provides Shippers with a formal route through which they can propose amendments to the Network Code. However, it should be noted that there are no proposals for Ofgem's suggested energy balancing incentive scheme to be incorporated other than in Transco's GT Licence, and the present proposal relates only to the anticipated energy balancing incentive. If this Modification Proposal is implemented, Shippers would still be at liberty to make informal representations to Ofgem if they believe that it would be in the interests of the industry and consumers for Transco's incentives to be modified. It should also be noted that Ofgem's proposals envisage the parameters of the energy balancing incentive scheme being set for two years initially and that wide consultation can be expected when proposals for subsequent years are developed.

Transco recognises that there may be proposals for further development of the energy balancing regime. However, Transco does not believe that migrating its NTS SO incentives into its GT Licence would prevent such development. If this Modification Proposal is implemented, the provisions that define Transco's and Shippers' obligations in relation to the operation of the energy balancing regime would subsist in the Network Code.

One respondent noted that the legal text that accompanied Draft Modification Report 0519 differed from the draft legal text that was submitted to the December Modification Panel in respect of this Modification Proposal. The draft legal text that was submitted to the December Modification Panel included a proposed amendment to Section F of the Network Code. The purpose of the amendment was to ensure that Transco may pay/receive incentive amounts via Commodity Charges. Following a review of the draft legal text Transco believes that the proposed amendment is not necessary. This amendment to the proposed legal text does not change the stated aim of this Modification Proposal.

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

Not Applicable.

**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**

Implementation of this Modification Proposal is not required in relation to any proposed change in the methodology established under Standard Condition 4(5) of the statement.

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

A program of works would not be required as a consequence of implementing this Modification Proposal.



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

It is proposed that the implementation of this Modification Proposal is aligned with the potential modifications to Transco's GT Licence and is implemented no earlier than 1 April 2002.

**16. Recommendation concerning the implementation of the Modification Proposal**

Transco recommends that implementation of this Modification Proposal is aligned with, and subject to, modification of Transco's GT Licence.

**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 to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

## 19. Text

### SECTION D: OPERATIONAL BALANCING, TRADING ARRANGEMENTS AND ENERGY BALANCING INCENTIVES

*Rename Section D as 'OPERATIONAL BALANCING AND TRADING ARRANGEMENTS'.*

*Delete paragraph 3.*

#### TRANSITION DOCUMENT PART II

*Delete text at paragraph 8.2.1 and insert new text and new paragraph 8.2.2 to read as follows:*

"8.2.1 In respect of the application of Section D3 in the period from 1 October 2001 up to (and including) the Day preceding the date of implementation of the Modification to the Code giving effect to this paragraph ("**relevant period**") (and by which modification Section D3 ceased to apply):

- (a) a reference to a Gas Year shall be treated as a reference to the relevant period;
- (b) amounts payable in respect of the relevant period by way of User Daily Incentive Amounts, User Annual Incentive Interest Amounts and User Annual Incentive Adjustment Amounts (under the Price Incentive Arrangement and the Linepack Incentive Arrangement collectively) shall continue to be invoiced and payable in accordance with Section S notwithstanding that such amounts are invoiced and payable after the relevant period; and
- (c) amounts payable under paragraph (b) shall be calculated in accordance with Section D3 as it applied immediately prior to the end of the relevant period.

8.2.2 For the purposes of paragraph 8.2.1 terms used therein shall have the meaning attributed thereto in Section D3 as it applied immediately prior to the date of implementation of the Modification to the Code giving effect to this paragraph."

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 **0519**, version **2.0** dated **15/02/2002**) 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 **2.0**.

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 appropriateprovided 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.