

Modification Report
Removal of Entry Capacity Incentives from the Network Code
Modification Reference Number 0520
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

Following the implementation of Modification Proposal 0488 'Redesign of Capacity Incentive Regime' entry capacity costs are handled via a neutrality process that operates independently of Transco's entry capacity incentive scheme. The Network Code provisions that give effect to the current entry capacity neutrality process and incentive scheme are transitional arrangements only. These transitional arrangements will expire on 31 March 2002.

The nature of this Modification Proposal is to migrate the existing transitional entry capacity neutrality provisions into the substantive body of the Network Code and to remove the entry capacity incentive scheme provisions from the Network Code. The entry capacity incentive scheme would instead be defined within Transco's 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 that this Modification Proposal is required to facilitate Ofgem's proposals to revise the structure of Transco's NTS System Operator (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 entry capacity incentive scheme from the Network Code into Transco's GT Licence. This migration would result in the distribution of NTS SO entry capacity incentive amounts being managed through Transco's GT Licence as part of the calculation of Transco's NTS SO allowed revenue. Accordingly, the Network Code would need to be amended to enable the payment of entry capacity incentive amounts to be managed via the proposed NTS SO Commodity Charge.

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

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

In the event that Transco's entry capacity incentives are incorporated into Transco's GT Licence, Transco believes that it would be necessary to remove the existing provisions that relate to entry capacity 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 be required to 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 entry capacity incentive scheme, however, it is envisaged that this effect would be offset by the inclusion of Transco's entry capacity incentive scheme into Transco's GT Licence as Transco proposes that the implementation of this Modification Proposal should be aligned with any relevant amendments to 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 entry capacity 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 entry capacity 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 change. 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:

Shipper	Shipper Reference
Scottish and Southern Energy Plc	SSE
Powergen	PWG
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

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 the principle that Transco's capacity incentive should be contained in its GT Licence and not in the NC;</p> <p>* Unable to comment meaningfully on the proposal until the proposed GT Licence amendments are published;</p> <p>* It would be more appropriate for there to be a concurrent consultation on the GT Licence framework and the NC changes;</p> <p>* There is a degree of uncertainty regarding what exactly will be included in Transco's GT Licence, translated into the NC and any additional risks that may be placed on Shippers, e.g. the proposed amendment to Section B.1.7.3.;</p> <p>* With the introduction of a new incentive for Transco it would be timely to reconsider how any Section I compensation payments should be recovered. In the context of the longer-term sale of entry capacity, SSE suggests that in the event that Transco is unable to manage constraints via buy back or other tools at its disposal, Transco should be exposed to the costs of such compensation, rather than to continue the current mechanism.</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>
BGGS		✗	<p>* This Modification Proposal is inevitable;</p> <p>* This Modification Proposal may improve the stability of Transco's incentives;</p> <p>* 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;</p> <p>* Concerned that the capacity regime is sufficiently in limbo to make this proposal a detrimental move. This proposal is premature.</p>
STUK	✓		<p>* This proposal is an essential part of the new SO incentives and to ensure consistency between Transco's GT Licence and the NC;</p> <p>* 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.</p>

BGT	✓	<ul style="list-style-type: none"> * 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; * Prior to implementation of the proposal there needs to be greater certainty as to the structure of the regime and interaction with the incentives; * If the proposed incentives have industry wide support they should be included within Transco's GT Licence; * Previous experience of incentives has shown that there may be a need to further amend the incentives; * 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.
Agip (UK)	✗	<ul style="list-style-type: none"> * SO entry capacity and entry capacity incentives should be retained within the NC rather than being migrated to Transco's GT Licence; * Including the incentives in the Network Code 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.
SGD	✗	<ul style="list-style-type: none"> * 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; * Only Ofgem can propose changes to Transco's GT Licence; * 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; * 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; * Ofgem has previously mis-forecast the requirement for Transco to buy-back capacity following the last auctions resulting in Transco making nearly £5m from October 2001 to March 2002; * 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; * 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.
Transco plc	✗	<ul style="list-style-type: none"> * 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;

TXU

* 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.

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 entry capacity 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 entry capacity incentive scheme to be incorporated other than in Transco's GT Licence, and the present proposal relates only to the anticipated entry capacity buy back 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 buy-back incentive schemes are 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 entry capacity 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 entry capacity regime would subsist in the Network Code.

One respondent referred to the proposed amendment to Section B1.7.3 of the Network Code and is concerned that this provision may introduce additional risk to Shippers due to the uncertainty of the exact drafting of the incentive provisions to be included within Transco's GT Licence. The affect of the proposed amendment to Section B1.7.3 would be to affirm that Commodity Charges may be used to manage the payment and receipt of incentive amounts if they are defined in Transco's GT Licence. Transco does not believe that this Modification Proposal introduces significant additional risk to Shippers.

One respondent commented that it may be timely to reconsider how Section I compensation payments should be recovered and in the context of the longer-term sale of entry capacity, Transco's cost exposure where it is unable to manage constraints via the tools at its disposal. Transco notes the comments made by the respondent. However, Transco believes that it would be more appropriate to discuss these issues at the relevant Workstream as they do not relate to the purpose 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 B: SYSTEM USE AND CAPACITY

Amend paragraph 1.7.3. to read as follows:

- 1.7.3. “..... Determined by reference to the quantity of the gas flow (or the part thereof attributable to a User) at a System Point, or a charge payable by reference to incentive arrangements contained in the Transco Licence.

Delete all text at paragraph 2.13, rename as 'Capacity neutrality arrangements' and insert new text to read as follows:

- 2.13.1 For each Aggregate System Entry Point the difference between amounts received or receivable and paid or payable by Transco in respect of Relevant Capacity Charges and certain other amounts in each calendar month shall be payable to or recoverable from relevant Users (and such amount shall not be reduced by any amount to be retained or borne by Transco).

- 2.13.2 For each Aggregate System Entry Point, in relation to each calendar month:

- (a) **"Relevant Capacity Revenues"** are the aggregate of the amounts payable to Transco by Users:

(i) by way of Capacity Charges in respect of Daily System Entry Capacity and Daily Interruptible System Entry Capacity at the Aggregate System Entry Point; and

(ii) where any User has negative Available System Entry Capacity, by way of System Entry Overrun Charges pursuant to (and calculated in respect of the amount determined under) Section B5.5.2(ii),

in respect of Days in the calendar month;

- (b) **"Relevant Capacity Costs"** are the aggregate of the amounts payable by Transco to Users by way of Capacity Surrender Charges and Aggregate Constraint Amounts pursuant to Section I3.7.2, in relation to the Aggregate System Entry Point in respect of Days in the calendar month.

- 2.13.3 In relation to each Aggregate System Entry Point and a calendar month, Transco shall pay to each relevant User an amount ("**Capacity Revenue Neutrality Charge**") determined as:

- (a) where one or more Users hold Registered Monthly System Entry Capacity at the Aggregate System Entry Point in relation to the calendar month:

$$RCR * URC / ARC$$

where:

RCR is the Relevant Capacity Revenues;

URC is the User's Registered Monthly System Entry Capacity; and

ARC is the aggregate of all Users' Registered Monthly System Entry Capacity, for that Aggregate System Entry Point in relation to the calendar month;

(b) where no User holds Registered Monthly System Entry Capacity at the Aggregate System Entry Point in relation to the calendar month:

$$RCR * AURC / AARC$$

where:

AURC is the aggregate of the User's Registered Monthly System Entry Capacity;

AARC is the aggregate of all Users' Registered Monthly System Entry Capacity;

and 'RCR' has the meaning in paragraph (a) above, for all Aggregate System Entry Points in relation to the calendar month (provided that in the event that no Monthly System Entry Capacity was held by any User at any Aggregate System Entry Point for the calendar month, 'AURC' and 'AARC' shall be determined on the basis of the most recent calendar month in respect of which a User held Monthly System Entry Capacity at an Aggregate System Entry Point).

2.13.4 In relation to each Aggregate System Entry Point and a calendar month, each relevant User shall pay to Transco an amount ("**Capacity Cost Neutrality Charge**") determined as:

$$RCC * AURC / AARC$$

where:

RCC are the Relevant Capacity Costs;

and 'AURC' and 'AARC' have the meanings in paragraph 2.13.3(b), for all Aggregate System Entry Points in relation to that calendar month;

2.13.5 For the purposes of this paragraph 2.13:

(a) the "**Capacity Neutrality Adjustment Amount**" for a calendar month (month 'm') is

(i) the sum of:

(1) the amount of any charge of a kind referred to in the definition of Relevant Capacity Revenues, and of any Capacity Neutrality Charge (payable to Transco), which was due for payment to Transco in month m-2 but were unpaid to Transco as at the last Day of month m:

(2) the amount of any interest paid (in accordance with Section S4.3.2) by Transco to any User on any Day in month m by virtue of the User having made an over-payment in respect of any of such amount as is referred to in paragraph (1) above;

less

(ii) the sum of:

(1) the amount of any charge of a kind referred to in the definition of Relevant Capacity Revenues, and of any Capacity Neutrality Charge (payable to Transco) which:

(A) was unpaid as at the last Day of month m-3 and was taken into account (under paragraph (a)(i) above) in calculating the Capacity Adjustment Neutrality Amount for month m-1, but

(B) has been paid to Transco since the last Day of month m-1;

(2) the amount of any interest paid (in accordance with Section S4.3.2) by any User to Transco on any Day in month m by virtue of late payment of any such charge as is referred to in paragraph (1) above;

(b) "**Capacity Neutrality Charges**" comprise Capacity Revenue Neutrality Charges, Capacity Cost Neutrality Charges and Capacity Adjustment Neutrality Charges;

(c) "**Relevant Capacity Charges**" comprise Relevant Capacity Revenues and Relevant Capacity Costs; and

(d) a "**relevant User**" is a User registered as holding Monthly System Entry Capacity at an Aggregate System Entry Point for the calendar month;

2.13.6 In relation to a calendar month (and all Aggregate System Entry Points), where:

(a) the Capacity Neutrality Adjustment Amount (if any) is negative, Transco shall pay to each relevant User; and

(b) the Capacity Neutrality Adjustment Amount (if any) is positive, each relevant User shall pay to Transco,

an amount ("**Capacity Neutrality Adjustment Charge**") determined as:

$$\text{CNAA} * \text{AURC} / \text{AARC}$$

where CNAA is the Capacity Neutrality Adjustment Amount and 'AURC' and 'AARC' have the meanings in paragraph 2.13.3(b) (provided that in the event that no Monthly System Entry Capacity was held by any User at any Aggregate System Entry Point for the calendar month, 'AURC' and 'AARC' shall be determined on the basis of the most recent calendar month in respect of which a User held Monthly System Entry Capacity at an Aggregate System Entry Point).

2.13.7 Capacity Neutrality Charges shall be invoiced and payable in accordance with Section S.

Amend paragraph 3.5.1(ii) to read as follows:

"3.5.1(ii) Commodity Charges ("**NTS Commodity Charges**") in respect of its use of the NTS on any Day, or a charge payable by reference to incentive arrangements contained in the Transco Licence."

TRANSITION DOCUMENT PART II

Delete paragraph 8.1.11.

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 **0520**, 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 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.