

URGENT Modification Report
Amendment to the Capacity Neutrality Arrangements
Modification Reference Number 0494

Version 1.0

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 buy-back arrangements for daily entry capacity, implemented by Transco's Pricing Consultation PC65, are due to commence on 1 October 2001 and therefore a decision on the outcome of this modification proposal will be required by the same date.

Procedures Followed:

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

Issued to Ofgem for decision on urgency	18 September 2001
Proposal agreed as urgent	19 September 2001
Proposal issued for consultation	20 September 2001
Close out for representations	24 September 2001
Final Report to Ofgem	26 September 2001
Ofgem decision expected	27 September 2001

1. The Modification Proposal

The proposal seeks to provide a mechanism within the network code to allow revenues to be rolled forward cumulatively to reduce cash flow exposure for holders of MSEC capacity. In allowing negative balances to be rolled forward against the next months allowance this would better facilitate the objective of PC 65 in rebating over recovery against Buy Back costs.

In the cumulative approach, instead of MSEC holders being required to fund £10m in October the -£10m would be carried forward to November and so on until the fund is fully utilised. If the buy back fund is fully utilised at the end of March 2001 any remaining cumulative buy back costs would be borne by MSEC holders in proportion to their aggregate holdings during the period 1st October 2001 to 31st March 2002.

2. Transco's Opinion

Transco is not in support of this modification proposal, and in general is opposed to modifications which change the contractual rules for entry capacity after the auctions for monthly system entry capacity have been conducted.

Transco acknowledges that consideration could be given to the relative merits of alternative methods for dividing auction excess revenue across the capacity period. Indeed, there has been extensive consultation on various options for

avoiding over-recovery relative to Transco's price control formula. The existing mechanism was introduced via a change to Transco's Transportation Charging Methodology, as proposed in Pricing Consultation PC65, and Transco believes that further changes to these arrangements should be introduced via the same route rather than via a change to the Network Code.

Transco notes that the Proposer refers to the creation of a "buy back fund" through implementation of Modification Proposal 0488 ("Redesign of Capacity Incentive Regime"). Transco would like to clarify that Modification 0488 introduces new incentives on Transco in respect of its performance against a target buy-back cost, but did not create a "buy back fund".

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

The proposer does not state how the proposed modification would better facilitate the relevant objectives, and Transco does not believe it would do so.

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

Transco does not believe there would be significant implications, but this is dependent on any impact on User behaviour .

b) development and capital cost and operating cost implications:

No such cost implications are envisaged.

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:

Implementation of the proposal would involve a change to the distribution of the auction excess revenues over the capacity period which requires a change to Transco's Transportation Charging Methodology.

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

No such consequences are envisaged.

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

No such implications are envisaged.

7. The implications of implementing the Modification Proposal for Users

Implementation of the proposal would increase the likelihood of the auction excess revenues being absorbed by the costs of "buy-back" and therefore of Users facing rebates, in proportion to their MSEC holdings, through their entry capacity charges rather than through general transportation charges.

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

No such implications are envisaged.

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

No such consequences are envisaged.

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

Advantages :

Increases the likelihood of excess auction revenue being used to reduce entry charges.

Disadvantages :

Introduces instability in costs that MSEC holders are likely to face as a result of capacity "buy-back" activity
Availability of the total fund at the beginning of the period may create undesirable incentives within the entry capacity regime.

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 nine parties, and from one party that requested their response to remain confidential :

BP	(BP)
Scottish and Southern Energy plc	(SSE)
Dynegy	(D)
Powergen	(P)
British Gas Trading	(BGT)
Marathon Oil	(MO)
ExxonMobil Gas Marketing	(EGM)
Alliance Gas Limited	(AGL)
Shell Gas Direct Limited	(SGD)

Six respondents express support for the proposal (BP, D, P, MO, EGM), one (SSE) expresses support for the underlying principle but states there has been insufficient time to properly think through all the consequences and three respondents do not support the proposal (BGT, AGL, SGD).

SSE expresses concern about the short consultation time afforded for consideration of the present modification proposal and the issues of constraint management and the buy back fund from 1 October 2001.

Two respondents (SGD, SSE) question whether it is possible to make changes to Transco's pricing methodology through modification of the Network Code, in order to accomplish the solution put forward in the modification proposal. SGD clarifies that (Pricing Consultation) PC65 introduced the "buy back fund" and that Modification 0488 introduced new incentives on Transco separate from PC65. SSE states it was its understanding that the principles behind the establishment of a buy back fund had been facilitated by a change to the transportation charging methodology and not the Network Code. SSE adds that it believes in order for a change to be effected a pricing consultation would have to be raised, and trusts that Transco will raise a transportation pricing consultation to enable these issues to be properly debated.

Three respondents (SGD, AGL) argue that changes should not be made to any confirmed arrangements made prior to the auctions after they have been completed with one respondent (BGT) stating that the rules which formed the basis of bidders valuations of the services auctioned should only be changed in very exceptional circumstances. BGT add that a dangerous precedent would be set if the rules regarding the treatment of over recovery were changed at this stage.

Five respondents raise explicit concerns about the present buy back fund framework (MO, SSE, EGM, D). Dynegy comments that a flat profile for the buy back fund is not representative of the likely costs the industry could experience. MO suggests that a buy back fund, profiled in line with the months the over-recovery occurred, would mean that more funds would be available to offset the costs in the months they were most likely to occur. SSE and one other respondent state that a profiled fund would produce a better matched profile with the benefit of reducing the chances of buybacks being funded through additional charges to MSEC holders. SSE suggests profiling by a methodology linked to the difference between $SND + 10\%$ and the volumes actually offered for sale in the auctions. EGM states that the modification proposal directionally helps ensure that the final price paid for MSEC is as close to the actual price paid at auction as possible and that it directionally reduces the size of the buyback fund remaining at the end of the Winter period which would be returned via a general k adjustment.

Powergen seeks further clarification about how any excess buy back fund amounts would be used with and without the implementation of this modification. SSE states that regardless of the outcome they expect Transco to

keep shippers appraised on a monthly basis of the value of the fund, the costs of constraints for that month, the amount paid out in entry rebates and the value of any carry forward to the next month.

Transco Response

Transco acknowledges the comments in support of a change to the way the "buy back fund" is spread across the capacity period, but as commented on by two respondents, such a change to a methodology that has been introduced as a change to Transco's Charging Methodology should not be achieved by a modification to the Network Code.

Transco also agrees with those concerns expressed regarding significant changes to the mechanism for redistribution of buy back costs and auction excess revenues after the auctions have been conducted, other than in exceptional circumstances.

In respect of the distribution of the buy-back fund, Transco acknowledges that further consideration could be given to the relative merits of alternative methods for dividing the auction excess revenue across the capacity period. However in Pricing Consultation paper PC65, Transco proposed that any excess revenue implied by auction outcomes would be spread equally over the six month auction period and it considers that a change would be undesirable at this time. Constraint management costs are difficult to predict and so a flat profile over the period could be considered as valid as any other methodology. In addition, availability of all excess revenues at the beginning of the period may create undesirable incentives within the entry capacity regime. Further to this, the level of any excess revenues could be small and therefore might all be consumed at the beginning of the period. Spreading any available excess uniformly over the period reduces possible distribution effects between users with different capacity profiles.

The PC65 approach is primarily a means of ensuring compliance with Transco's Price Control rather than compensating MSEC holders for buy back costs. In accounting terms therefore the period in which the excess is refunded should be linked to the period during which it occurred. If profiling were to be introduced, therefore, it may be more appropriate to follow auction amounts rather than buy back costs, an option that has been put forward by two respondents.

Transco believes that the mechanisms for dealing with under or over recovery of revenue in any formula year are clearly established in the Transportation Charging Methodology. That is, it will be included in the calculation of the K adjustment factor.

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

Implementation of this proposal is not required to enable Transco to facilitate compliance with safety or other legislation.

- 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**

Not applicable.

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

No such programme of works would be required.

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

An implementation timetable has not been considered as transco is not in support of this Modification Proposal.

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

Transco recommends that the Modification Proposal is not implemented.

- 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
Manager, Network Code

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 **0494**, version **1.0** dated **26/09/2001**) 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 **1.0**.

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.