URGENT Modification Report
Release of ASEP maximum System Entry Capacity Volumes for MSEC Auction
Modification Reference Number 0481

Version 2.0

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 any changes to the structure of the NTS Entry Capacity auction regime will need to be made in a timely manner prior to 13 August 2001, the scheduled commencement date of the auctions for Entry Capacity over the period 1 October 2001 and 31 March 2002. Provision of Urgent status should allow Transco time to issue an amendment to its invitation to the auction and provide sufficient time for shippers to amend their bidding strategies if the proposal is accepted.

Procedures Followed:

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

Issued to Ofgem for decision on urgency	20 July 2001
Proposal agreed as Urgent	20 July 2001
Proposal issued for consultation	20 July 2001
Close out for representations	27 July 2001
Final Report to Ofgem	31 July 2001
Ofgem Decision expected	02 August 2001

1. The Modification Proposal

This Modification Proposal has been raised by Conoco and is intended to maximise the volume of capacity released for auction within the reasonable bounds of what shippers believe Transco may be able to make available physically on the day, without making assumptions about the level of demand or distribution of supplies at entry points.

The proposal involves setting the MSEC quantities for each ASEP for each month equal to the highest of the monthly ASEP Maximum System Entry Capacities published by Transco under its invitation to auction letter dated 29 June 2001. For avoidance of doubt this would mean setting the MSEC quantities at St Fergus for all months, equal to 1492.7 GWhr/d and for Bacton to 1216.3 Gwhr/d etc. Hence giving the perception to the bidding shipper of adequate capacity levels. The auction process will remain the same in that the volumes would be auctioned over 4 rounds with any unsold in 5th round being conducted under the existing Network Code rules. The MISEC, DSEC and DISEC capacity auctions will also remain to cover unsold volumes and UIOLI capacity on the day.

By making more capacity available to shippers the chance of excessive prices directionally reduces and that may encourage shippers to be more willing to sell capacity either on the secondary market or to Transco for buy back whenever the need arises at a reasonable price. Transco has the option to buy back at different, “cheaper” terminals directing capacity to terminals of higher demand. It would be expected to have the added effect of reducing over recovery.

2. Transco’s Opinion

Transco does not support this Modification Proposal. The present design of entry capacity allocation arrangements is based upon offering MSEC capacity in quantities that are close to physical capability. Daily processes have been designed around this to fine tune capacity release and constraint management. A substantial shift in MSEC availability as proposed would in Transco's opinion have consequences that should be considered for all other aspects of the entry capacity regime. It believes that an increase in the volume of capacity released to the ASEP Maximum System Entry Capacity published by Transco could increase the likelihood of capacity constraints leading to buy-back costs and a reduced potential for incremental sales of entry capacity. Taken together this would present a substantial change to the risk / reward profile for both Transco and Users via the capacity incentive. Transco accepts that this could be mitigated by a re-assessment of the format of the capacity incentive but would argue that there is not sufficient time to carry this out before the start of the next set of entry capacity auctions on 13 August 2001.

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

In the proposer's view, the proposal would ensure that the volume of capacity offered for sale is closer than the current methodology to maximum physically achievable level of capacity release. It is believed that this should "have the effect of reducing uncertainty and the risk of price escalation as well as maximising the opportunity for all supplies to compete for market access."

However, in Transco's view this proposal would be less likely than the present arrangements to facilitate a number of objectives. Selling capacity beyond physical capability removes the benefit to Transco of a capacity signal that should provide an advance indication of shipper requirements. Over selling implies that Transco must exercise greater judgement as to the location of expected shipper nominations when planning its operations.

An over provision of capacity could in some instances remove the scarcity that created a need for an auction allocation process. Instances of no scarcity may best be addressed by providing cost reflective charges rather than the discounted reserve prices that are available in Monthly System Entry Capacity (MSEC) auctions. A combination of over provision and discounted prices implies that capacity could be available at a substantial discount to marginal cost.

The present Network Code provisions provide a "right first time" approach to capacity management in the belief that is the best manner for economic and efficient operation of the pipeline system. That is, all the capacity that might reasonably be considered to be available is offered in the MSEC auctions and the daily processes are reserved for fine tuning. It is not clear that substantial over selling and then reliance upon constraint management to manage capacity allocation will be more efficient than the present process. Indeed this is the precise circumstance that gave rise to the development of a capacity product that is more readily identifiable as "firm".

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

a) implications for the operation of the System:

The Modification Proposal would require Transco to release volumes of MSEC that correspond to the highest monthly ASEP Maximum System Entry Capacities that are published and are in general above Transco's estimate of physical capability. Transco will then need to manage on a daily basis a system that has released more firm capacity than can be honoured and that also requires a substantially increased quantity of interruptible capacity to be released ahead of each gas day. Both factors are likely to generate more frequent constraint management and could increase risks of significant additional flow rate changes on the pipeline system.

b) development and capital cost and operating cost implications:

No implications on development, capital and operating costs are envisaged as a consequence of implementing the 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:

Not applicable.

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 considers that a change in the level of contractual risk under the capacity incentive within the Network Code is probable, because increased release of MSEC would be expected to generate a step change in the level of capacity buy-back to manage entry capacity constraints. The proposal would also greatly reduce the extent of incremental daily sales of capacity.

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

Implementation of this Modification Proposal would have no implications for the computer systems of Transco.

Transco is unaware of any development implications for the RGTA related computer systems of Users, other than modifications to shipper capacity risk management processes. This latter aspect is relevant to shipper exposure to capacity buy-back costs.

7. The implications of implementing the Modification Proposal for Users

If the proposal is implemented Users would have an opportunity to acquire larger quantities of capacity in the MSEC auction than is presently available. Users would need to assess the impact of this change to the auction regime on their bidding strategies for the forthcoming MSEC auctions, which are due to commence on 13 August 2001.

Users would also need to assess the impact of the increased constraint management costs associated with a regime that can release capacity quantities that are possibly significantly above physical capabilities at individual entry points. That risk at present is managed through the capacity incentive process for which 80% of costs are paid by MSEC holders. The aggregate shipper risk increases to 100% of incremental costs when monthly costs exceed £416,666.

Users will also need to re-assess their approach to using interruptible entry capacity. As presented the proposal suggests that the quantity of Monthly Interruptible System Entry Capacity (MISEC) will be much reduced but that there will be a significant increase in Daily Interruptible System entry Capacity (DISEC). That increase will occur because the availability of DISEC is based upon an estimate of the quantities of unused MSEC, which can reasonably be expected to increase. A significant increase in DISEC may require Transco to invoke scaling back of interruptible capacity more frequently and to a greater extent than previously expected.

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

Transco considers that the above parties will need to consider the implications of Transco offering entry capacity that does not bear much resemblance to physical capability. In particular the above parties should consider carefully how they will accurately assess Transco's pipeline capability in the future.

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

Users should consider the appropriateness of processes that it may have established to ensure that it does not prejudice the safe and efficient operation.

from day to day, by Transco of its pipe-line system. In particular Users will in some circumstances be able to drive constraint management costs by demanding gas flow in a manner that it knows Transco cannot deliver.

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

Advantages :

Increased availability should tend to reduce bid prices.
Increased capacity availability may produce "more" stable prices between auction rounds
Users may be more willing to sell capacity via the secondary market
The proposal would reduce reliance on historic gas flow information when allocating MSEC to each ASEP.

Disadvantages :

The proposal adds a degree of uncertainty in the run up to the next NTS Entry Capacity auctions.
There would be a greater probability of the buy back of entry capacity being required.
The Capacity Incentive risk/reward profile would be substantially changed for both Users and Transco.
Interruptible entry capacity may be exposed to more frequent scale back.
Incremental sales of daily capacity would probably be reduced.
The fifth MSEC auction round is likely to be inoperable because the quantities offered in rounds 1 to 4 exceed the fifth round monthly maxima.
Transco system capability is not signalled by the quantities offered at 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 parties:

TotalFinaElf Exploration UK PLC	(TFE)
TotalFinaElf Gas and Power Limited	(TFEG&P)
Conoco (UK) Limited	(Conoco)
Phillips Petroleum Company United Kingdom Limited	(Phillips)
Powergen	
British Gas Trading	(BGT)
Enron Europe Limited	(Enron)
Shell Gas Direct Limited	(SGD)
Alliance Gas Limited	(AGL)
Marathon Oil UK Ltd	(Marathon)
Northern Electric and Gas Limited	(NEAGL)
Chevron UK Limited	(Chevron)
ExxonMobil Gas Marketing	(ExxonMobil)
Scottish and Southern Energy	(SSE)

Five respondents (Powergen, BGT, Enron, SGD and NEAGL) are not in support of the Modification Proposal.

Powergen, BGT, Enron and SGD all express support for the principles of the proposal and agree that it could alter market perceptions over the amount of capacity available, which could potentially lower the prices bid in the auction and reduce the likelihood of an over recovery. However, all have concerns over implementing such a change to the regime prior to the next Monthly System Entry Capacity auction. Powergen considers that the outcome of introducing the methodology proposed under this proposal would be very uncertain and suggests Ofgem would need to balance this against the possible benefits of introducing a more robust methodology for determining entry capacity quantities. BGT, Enron and SGD suggest that there should be a thorough assessment of the whole regime which should include Transco's incentives, the work on long term products and the provision of investment signals.

Enron and NEAGL believe that the proposal is inconsistent with the current structure of Transco's incentive, which is designed to encourage the release of additional daily capacity, and does not address the inequitable distribution of shipper exposure to buy back costs. Enron considers that shippers at constrained terminals are being subsidised by MSEC holders elsewhere and, as they are not subject to the full costs of a constraint, this reduces the incentive for shippers at constrained terminals to sell capacity back to Transco.

NEAGL and BGT also consider that the proposal would have a significant impact on the balance of capacity incentive and increase the risk to MSEC holders of buy backs. SSE shares the concerns over the impact on Transco's incentive and the distribution of buy back costs although it is in support of the proposal and argues that the increased quantities of capacity made available should mitigate these risks if prices bid in the auctions are reduced. However, BGT does not envisage that the possible lower cost of purchasing capacity in the auctions would be fully reflected in the cost of buy backs.

Powergen, Enron and SGD question whether the proposal would necessarily reduce the probability of revenue over recovery. They suggest that the increased quantities available could lead to shippers to bid for volumes of capacity in excess of what would be bid for under the current regime. Motives for this could be to insure themselves against capacity scaleback in the event that there are insufficient buy back offers to meet a constraint or in order to take advantage of a possible commercial opportunity to earn buy back revenue. This scenario is also highlighted by ExxonMobil although it is in support of the proposal.

Powergen raises concerns that the SND+10% figures for capacity availability, which have already been published by Transco, could be taken as a benchmark of the likely level of capacity Transco would be able to make available and, in turn, give an indication of the likelihood of buy backs.

SGD also notes that Ofgem is yet to publish the results from its investigation into the buy back market following the events in October 2000 and until these are released there is considerable uncertainty in the industry as to what constitutes acceptable behaviour by shippers in relation to the buy back regime.

SGD suggests Transco should focus on increasing transparency over capacity availability figure and welcomes the information recently given by Transco at an RGTA meeting on capacity availability for the "Northern Triangle". ExxonMobil also summarises the information given at this meeting and provides details of a comparison between capacity availability for the "Northern Triangle" under this Modification Proposal and the capacity levels Transco has calculated to be the physical maximum capacity under seasonal normal conditions.

NEAGL believes that changes to the MSEC quantities that have already been published are not acceptable at this stage and would only serve to create further uncertainty in understanding the nature of the products being auction and their relative values. This view is also shared by SSE, which considers that there is considerable uncertainty over the impact of the late changes proposed for the regime on biding behaviour.

SSE is in support of the proposal but comments that Interruptible Entry Capacity would become "worthless" due to the increase in the likelihood of interruption. SSE also raises concerns over the potential lack of OTC capacity and the fact that there would be no restrictions on the volume of capacity that can be held by an individual shipper. However, it notes that more OTC capacity could be made available if the perceived shortage of capacity is reduced. BGT stresses that a pre requisite of the introduction of a "top down" regime must be that a transparent secondary market is in place, which is not currently the case.

Nine respondents (TFE, TFEG&P, Conoco, Phillips, AGL, Marathon, Chevron, ExxonMobil, SSE) are in support of the Modification Proposal, believing that it is likely to weaken the perception that there is a scarcity of capacity, which should moderate the prices bid for capacity in the auction and reduce the likelihood of a further over recovery of revenue.

TFE, TFEG&P and Phillips consider that the Modification Proposal is an improvement on Modification Proposals 0477 (Fifth Round Monthly System Entry Capacity Allocation) and 0480 (Fifth Round Monthly System Entry Capacity) as it would lead to a significant increase in the volume of entry capacity available at an ASEP. SSE also argues that shippers are unlikely to risk waiting until the fifth round to secure their capacity requirements and therefore any proposal which only leads to an increase in capacity in the fifth round would not be likely to reduce the upward pressure on prices.

A number of respondents in support of the proposal consider that it may increase the possibility of Transco taking buy back actions. However, TFEG&P believes that the buy back market now operates as a "competitive and liquid trading mechanism" and provides the tool to appropriately to manage constraints. Conoco also considers that the constraint management tools available to Transco under the current regime, and the fact that a finite amount of capacity would be sold under this proposal, would effectively remove the risks related to system security and the generation of significant market costs, which had previously associated with a "top down" regime. Chevron expresses a preference for the use of buy back as a constraint management tool as opposed to TFAs, which it considers are "against the spirit of the RGTA process".

A number of respondents express the opinion that there would not be a significant increase in buy back as a result of implementing this Modification Proposal. Marathon believes that in the past Transco has been "overly cautious" in the degree it exposes itself to the risk of buy back and estimates that the reduction in purchase price of capacity would offset the likely increase in buy back costs. Conoco is of the opinion that the number of buy back days which would occur this winter would be similar to the number that occurred over winter 2001. AGL also suggests that on an aggregate basis the increase in the capacity would not be significant when compared to the total MSEC and daily firm capacity released over last winter. ExxonMobil considers that there may be a higher level of buy back exposure, however, it comments that this is difficult to assess at present as to date Transco has not extracted the full level of potential benefits from buy back competition at the "Northern Triangle" entry points.

Conoco suggests that the flexibility between terminals is greater than previously believed and therefore additional competition could be brought to the market by Transco electing to buy back at "cheaper" entry points rather then the constrained entry point. Phillips also urges Transco to make use of the flexibility inherent in the system and, when constraints arise at St. Fergus, buy back capacity at the cheaper northern terminals. ExxonMobil considers that Transco would be given more flexibility to optimise any buy back actions. However, it also warns that this could introduce complexities which could impede Transco in its operation of the system.

AGL suggests that a "buy back" fund could be set up to mitigate any change to Transco's risk- reward position and could possibly be funded by the over recovery revenue rather then the current mechanism , which AGL believes is discriminatory and creates a "severe distortionary effect". AGL also considers that the definition of "Maximum System Entry Capacity" is misleading as it does not reflect the physical capability of the system on a given day.

Conoco believes that the hoarding of capacity should not be a problem as the cost of capacity purchased in the auction is still likely to be higher than the prices paid for capacity pre RGTA and the introduction of NTS Entry Capacity auction regime. Chevron notes that the Use-it-or-lose-it mechanism would continue to be in place as an anti hoarding mechanism. Chevron also believes that an increase in the quantity of capacity available in the primary auctions is also likely to encourage liquidity in the secondary market as it would encourage shippers with surplus capacity offer it for resale.

ExxonMobil discusses the buy back risk at Southern terminals in its representation and argues that for these entry points the release of greater volumes of entry capacity are not likely to lead to any significant buy back risk. ExxonMobil sets out its reasoning behind this assertion in its representation and requests views from Transco on this premise.

TFEG&P considers that "fundamental flaws" remain in the use of an auction process to allocate a finite amount of entry capacity within a regulated Price Control. TFEG&P, Marathon and Conoco express concerns over the over recovery of allowed revenues that has occurred to date and the discriminatory impact of the redistribution of these revenues. Marathon believes that the current revenue redistribution mechanism is particularly discriminatory against producer shippers and urges for this area to be addressed as a priority. Phillips, ExxonMobil and AGL suggest that the proposal should be implemented as an interim measure pending further discussions in the industry on the entry capacity regime and long term capacity arrangements.

Transco response

Transco welcomes the high level of debate that this proposal has generated and views respondents concerns to improve the entry capacity regime as a positive portent for development over the medium term of capacity allocation arrangements. Transco does share the concerns of a number of Users that change of the scale proposed needs to be fully discussed and considered prior to implementation. The limited consultation of this proposal does not fulfil that requirement and consequently there are a number of significant issues that have not been addressed. The Proposer argued that it wished to avoid Transco exercising its discretion when determining MSEC allocation. Transco refutes that suggestion and would observe that the proposal does not remove any of the present capacity determination methodology from the Network Code, it merely adds a greater of rule to the existing requirements. More fundamentally a number of Users have identified the significant change in risk and reward profile associated with the capacity incentive, which will continue to impact upon both Users and Transco. Further consideration is also required for the use of Interruptible capacity in a world where MSEC availability is expected to routinely exceed actual capability. Both the Capacity Incentive and the use of Interruptible Capacity are substantive areas impacted by this proposal and deserve due consideration before a step change in capacity availability is implemented.

Transco recognises the concerns of Users regarding uncertainty and the prices bid in past MSEC auctions. However, consideration should be given to the equitability of substantially discounted reserve prices where commercial scarcity is removed. The combination of which may lead to upward adjustments to NTS commodity charges to meet Transco's allowed revenue targets.

Transco has considerable concerns that the buy-back "market" has been, and will continue to be less liquid than the primary allocation process which itself is not viewed to be highly competitive. This has contributed in the past to a significant mark-up of prices offered to Transco in the buy-back process. A number of Users have argued that if a greater quantity is made available then a lower average price can be expected in return. However, Transco believes that total costs could still be significantly larger than recently experienced. For example, initially redundant capacity may be obtained at a low unit cost but this will not impact upon levels of gas flow. As Transco buys through the buy-back capacity on offer the prices will progressively rise. There is no reason to expect that prices required to turn down actual flow will be any lower than at present. This rationale is based on an observation that Users can ultimately surrender capacity and purchase alternate supplies at the NBP. In aggregate Transco is likely to have purchased much more capacity with the highest prices, as now, bearing a relationship to the NBP alternative.

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

Implementation 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

The proposal if implemented, would require Transco to re-calculate reserve prices in accordance with the established methodologies for all categories of entry capacity. At present the Network Code specifies a 2-month notice period is required prior to implementation of new charges.

14. Programme of works required as a consequence of implementing the ModificationProposal

As no changes are required to the UK-Link systems a programme of works would not be required as a consequence of implementing the Modification Proposal.

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

An Ofgem decision on the proposal is expected on 2 August 2001. If the proposal is approved on this date Transco would suggest an implementation date of 10 August. The need for a number of consequential modifications may need to be considered for implementation prior to the MSEC auctions of summer 2001.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend that this Modification Proposal is 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

19. Text

Transition Document Part II

Add new paragraph 8.1.3.A to read as follows

" 8.1.3.A

B.2.3.2.b. In respect of the calendar months October 2001 to March 2002 (inclusive) (each a **"Relevant Month"**) for the purposes of Section B2.3.7:

(1) the Available Monthly Capacity in respect of an Aggregate System Entry Point for each Relevant Month shall equal an amount of System Entry Capacity equal to the highest amount of Maximum System Entry Capacity For the Aggregate System Entry point set out by Transco in the invitation sent out to Users in accordance with Section B.2.3.1 for the Relevant Months; and

(2) in respect of the fifth invitation date, the Aggregate Actual Outstanding System Entry Capacity for a Relevant Month shall equal the amount by which the Available Monthly Capacity (determined in accordance with (1) above) at all Aggregate System Entry Points exceeds the Monthly System Entry Capacity for the time being held by Users at all Aggregate System Entry Points.”

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 **0481**, version **2.0** dated **13/08/2001**) 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 **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 <u>(whether such approval is actual or deemed by effluxion of time)</u> 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, <u>had it not been repealed, would</u> 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) <u>or 2(2)(b)(ii)</u> 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.