URGENT Modification Report
Fifth Round Monthly System Entry Capacity Allocation
Modification Reference Number 0477

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 because any changes to the structure of the NTS Entry Capacity auction regime would 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 would allow Transco to issue an amendment to its invitation to the auction and provide 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	12 July 2001
Proposal agreed as Urgent	13 July 2001
Proposal issued for consultation	13 July 2001
Close Out for Representations	20 July 2001
Final Report to Ofgem	24 July 2001
Ofgem decision expected	26 July 2001

1. The Modification Proposal

This Modification Proposal is intended to increase the level of competition for Monthly System Entry Capacity (MSEC). In particular it will enable larger quantities to be offered in what is known as the 5th round of MSEC auctions. The proposal below does not imply any change to the method of calculating Determined System Entry Capacity or Available Monthly Capacity with respect to each Aggregate System Entry Point (ASEP).

It is proposed that 90% of Determined System Entry Capacity is offered in equal sized tranches for rounds 1 to 4 of the MSEC auctions.

The residual quantity, offered in round 5, will comprise a minimum of 10% of Determined System Entry Capacity plus any quantities remaining unsold from the preceding auction rounds.

The Network Code rules for operating round 5 will remain unchanged from the present arrangements in all other respects . Shippers will consequently be afforded an opportunity to bid for a greater proportion of Determined System Entry Capacity through round 5.

2. Transco's Opinion

Transco put forward this proposal as it considered that it would lead to a greater volume of entry capacity being released in the fifth round of the auctions, where there is a degree of competition between Aggregate System Entry Points (ASEPs). The proposal would also place a greater weighting upon the commercial requirements of Users when determining the allocation of capacity between ASEPs. However, Transco also recognises the concern expressed by the majority of respondents that the proposal could lead to a perception that capacity was being restricted in the first four rounds, and that the impact of this on bidding strategies would need to be taken into account.

Transco wishes to avoid implementation of any measures that are not perceived to further its relevant objectives and, therefore, in the light of the responses received Transco does not support implementation of this proposal.

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

The Modification Proposal would further reduce reliance upon historic gas flow figures when allocating MSEC to each ASEP. Ensuring that at least 10% of Determined System Entry Capacity is made available in the fifth round of MSEC auctions would allow Users to obtain larger quantities of capacity on a competitive basis. This should result in a higher level of shipper to shipper competition and a greater responsiveness to forward looking commercial requirements, therefore furthering the relevant objective of facilitating effective competition.

Allocation of a larger proportion of capacity through a competitive fifth round should also further the economic and efficient operation of the system as it would enable increased quantities to be allocated to ASEPs in line with Users' commercial requirements, as reflected through their bid valuations.

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

a) implications for the operation of the System:

No implications for the operation of the System are envisaged. The proposal would not increase the total volume of capacity released across all ASEPs and the capacity available at an individual ASEP would not be higher than the maximum deliverability of that ASEP.

b) development and capital cost and operating cost implications:

No implications on development, capital or 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 does not envisage any change in the level of contractual risk under the Network Code as a consequence of implementing the Modification Proposal.

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 development implications for the computer systems of Transco.

Transco is unaware of any development implications for the related computer systems of Users.

7. The implications of implementing the Modification Proposal for Users

If the proposal is implemented Users would have a greater opportunity to acquire capacity in the fifth round of the MSEC auction, where capacity can be bid for at any ASEP. Users would need to assess the impact of this change to the auction regime on their bidding strategies for the forthcoming NTS Entry Capacity auctions, which are due to commence on 13 August 2001.

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

Transco does not envisage any implications of implementing the Modification Proposal for the above parties.

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 consequences are envisaged on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party as a result of implementing the Modification Proposal.

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

Advantages :

The allocation of capacity to each ASEP would be carried out with reduced reliance on historical gas flow information and a greater responsiveness to forward looking commercial requirements.

The proposal would enable more capacity to be offered for use at places where shippers value it most highly. Shipper to Shipper competition would be enhanced because quantities from non-competitive ASEPs would be drawn into the 5th round allocation.

Disadvantages :

The proposal adds a degree of uncertainty in the run up to the next NTS Entry Capacity auctions. Shippers would need to account for the late change in the structure of the auction and amend their bidding strategies accordingly.

The reduction in the volume of capacity made available in the first four rounds and the increase in competition for entry capacity between ASEPs as a result of a greater amount of capacity being made available in the fifth round could place an upward pressure on the prices bid for capacity in the auction.

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

Representations have been received from the following parties :

Enron Europe Limited (Enron)
British Gas Trading (BGT)
Scottish and Southern Energy (SSE)
Shell Gas Direct Limited (SGD)
Chevron UK Limited (Chevron)
TXU Europe Energy Trading Limited (TXU)
BG Group (BG)
Alliance Gas Limited (AGL)
Conoco (UK) Limited (Conoco)
Powergen
Innogy
BP UK Gas and Power (BP)
Northern Electric and Gas Limited (NEAGL)
TotalFinaElf Exploration UK PLC (TFE)

Only Powergen supports implementation of the proposal. Powergen believes that allowing Users flexibility to choose the entry point where they wish capacity to be made available would maximise the availability of capacity at St. Fergus and should help to reduce the prices bid for St. Fergus capacity in the auction.

Powergen also considers that it is preferable for the MSEC auction to provide more information to Transco on User preferences for entry capacity availability, rather than the within day capacity mechanism.

Powergen notes, however, that the merits of the proposal would only exist if capacity can be substituted to St. Fergus from other northern terminals, such as Teesside and Barrow. It argues that if capacity is transferred from entry points with minimal inter-dependence with St. Fergus then the result would be an overselling of capacity and an increased probability of buy backs. Powergen urges for Transco to "accurately match the amount of entry capacity sold at a particular terminal to their likely ability to make available such capacity at a given terminal at a given time of year. "

Innogy and Chevron welcome the intention of the proposal to increase flexibility in the manner MSEC is allocated between ASEPs and take more account of future gas flows from new onshore developments. Chevron argues that this should improve the working of the Entry Capacity auction regime and the subsequent OTC market. Chevron considers that the proposal would have some benefits in terms of allowing capacity from "low price ASEPs" to be made available to shippers that are prepared to pay high prices. However, Innogy goes on to detail the problems it perceives with this proposal and Chevron indicates that it would prefer the solution proposed under Modification Proposal 0480.

All other respondents (TFE, NEAGL, BP, Enron, BGT, SSE, SGD, TXU, BG, Alliance and Conoco) do not support the proposal.

The majority of respondents (TFE, NEAGL, BP, Innogy, Enron, BGT, SSE, SGD, Chevron, TXU, BG, AGL, Conoco) consider that a reduction in the volume of capacity made available in the first four rounds could lead to the perception that capacity was being restricted, leading to an increase in the level of uncertainty in the market that could have a consequential impact on bidding strategies and result in an increase in the prices bid for capacity.

AGL highlights that in previous auctions there has been a trend for significant price escalation to be seen in earlier rather than later auction rounds and considers that this proposal would be likely to accentuate this trend. TXU notes that the proposal could lead to an increase in competition for capacity in the fifth round, which could drive up prices in this round. SSE considers that, although there would be an increase in the volume of capacity made available in the fifth round, many shippers will not want to risk leaving it until this round to secure their capacity entitlements.

NEAGL draws attention to the additional nine mcm of entry capacity sold at St. Fergus in the fifth round of the auction covering last winter and suggests that this may have contributed to the increase in the volume of buy back actions over the winter. As 80% of the costs of buy back actions are smeared over all MSEC holders, NEAGL urges against the introduction of further arrangements which could encourage constraints.

A number of respondents (Enron, BGT, SSE, SGD, Chevron, TXU, BG, Alliance, Conoco) ultimately believe that the proposal could exacerbate the potential for a further over-recovery of revenue in the auction. BG considers that to date Transco has failed to address the industry concerns over the current over-recovery redistribution mechanism and any proposal which increases the likelihood of a further over recovery should be viewed as contrary to furthering the relevant objectives and should not be implemented.

AGL, BGT, BG, TFE, Conoco and SGD question whether the proposal would have any benefits for the regime as the total volume of capacity made available would remain unchanged. SGD considers that the proposal would only make a difference at limited times when capacity at all terminals has sold out in the first four rounds. BG argues that previous experience over winter periods would indicate that not all capacity will be sold in the first four rounds and therefore capacity would still go to terminals where it is valued most highly. Conoco is of the opinion that there would be a "minimal improvement" at non-competitive terminals at the cost of more aggressive competition for capacity at the more competitive and constrained terminals, such as St. Fergus.

BGT disputes the assertion that Transco's relevant objectives would be furthered by an increase in shipper to shipper competition. BGT argues that instead there is likely to be an increase in "terminal to terminal competition, with shippers being unable to change terminals". AGL considers that the proposal would result in greater amounts of capacity being allocated to less competitive terminals in the fifth round, rather than increasing capacity availability at any terminal where competition is at its highest.

Enron, SGD, BG and TFE highlight other issues which should be addressed, rather than how capacity is allocated between entry points. Enron, BG and TFE believe that more attention should be given to the aggregate volume of capacity which is made available. TFE is of the opinion that any proposal in this area must introduce additional entry capacity above the current maximum MSEC quantities stated by Transco, especially at St. Fergus. SGD further comments that the proposal does not address the lack of transparency in the quantities made available and other distortions in the current auction regime, for example, the over recovery redistribution mechanism, which it argues should be the main focus of Transco's and Ofgem's attention.

AGL urges for Ofgem to make a timely decision on the Modification Proposal in order to allow Users time to finalise their bidding strategies ahead of the auction.

Transco Response

Transco welcomes the high level of responses to this proposal. It considered that the possibility of furthering its licence objectives by changing the ratio of capacity offered in each auction round should be raised to facilitate debate upon the desirability of pursuing further incremental increases in efficient operation and shipper to shipper competition. In light of respondent's views Transco recognises the concerns raised regarding the possibility of escalating bid prices and consequently does not support implementation of this proposal.

Transco believes that Modification Proposal 0477 would increase the possibility that the maximum capability at St Fergus could be reached. At St Fergus, as with other ASEPs, the maximum quantity that could be allocated remains unchanged. However, under present arrangements if all capacity is allocated in rounds 1 to 4 then St Fergus would receive 1192 GWh in October.No further capacity could then be allocated at that location. With Modification Proposal 0477 St Fergus could be allocated 1083 GWh in rounds 1 to 4 with 299 GWh remaining to be allocated in round 5. The maximum potential at St Fergus in both cases is 1251 GWh.

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

Not applicable.

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 27 July 2001. If the proposal is approved on this date Transco would suggest an implementation date of 31 July 2001.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not support implementation of the Modification Proposal.

17. Restrictive Trade Practices Act

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

18. Transco's Proposal

19. Text

No legal text is provided as Transco is not in support of this Modification Proposal.

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 **0477**, version **2.0** dated **24/07/2001**) 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.