URGENT Modification Report
Adjustment to ASEP Capacity Revenue Neutrality calculation
Modification Reference Number 0490

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 changes to the apportionment of costs arising from likely increased buy back volumes (following the introduction of Modification Proposal 481) may impact Shippers bidding strategies in the forthcoming auctions scheduled to take place on 29 August 2001 covering the period 1 October 2001 to 31 March 2002. A decision on this Modification Proposal is therefore required prior to commencement of these auctions to enable the impact of this Modification Proposal to be factored into Shippers bidding strategies.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:
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Issued to Ofgem for decision on urgency	22 August 2001
Proposal agreed as Urgent	22 August 2001
Proposal issued for consultation	22 August 2001
Close out for representations	23 August 2001
Final Report to Ofgem	24 August 2001
Ofgem Decision expected	24 August 2001

1. The Modification Proposal

This Modification Report covers both Modification Proposal 0490 and 0490a. Modification proposal 0490 was raised by BG Gas Services Ltd and Modification proposal 0490a was raised by Transco to add clarity to 0490. Each is described below:-

Modification Proposal 0490

This Modification seeks to change the apportionment of capacity buyback costs on a more cost reflective basis

It is proposed to apportion Capacity Incentive Costs incurred on a Day between Shippers as follows:

50% of Effective Capacity Entitlement at the Constrained ASEP(s). (This includes MSEC, MISEC (where applicable), effective DAI and WDF entry capacity).

Plus

50% apportioned across all ASEP MSEC entry capacity (as at present).

These costs would be targeted to Users holding the effective capacity on a Day, rather than the initial relevant User of the capacity calculated on a Monthly basis.

Modification Proposal 0490a

This Modification Proposal seeks to change the apportionment of capacity buyback costs on a more cost reflective basis

It is proposed to apportion Capacity Incentive Costs incurred on a Day between Shippers as follows:

50% of Effective Capacity Entitlement at the Constrained ASEP(s). (This includes MSEC, MISEC (where applicable), effective DAI and WDF entry capacity, adjusted for accepted buy back bids and shipper to shipper trades).

Plus

50% in proportion to a Shippers Effective Entitlement (as defined above) at all ASEP's.

These costs would be targeted to Users holding the effective capacity on a Day, rather than the initial relevant User of the capacity.

2. Transco's Opinion

Transco observes that both Modification proposals include two principle elements:

- daily buy-back cost allocation (rather than monthly)
- splitting daily buy-back costs on a 50/50 basis with the first sum apportioned against the effective capacity for the day at the location that the buy-back costs were incurred and the second sum being apportioned against the effective capacity "nationally".

The principle differences between the two are as follows:-
Modification Proposal 490 proposes that the amount apportioned nationally is on the same basis as now i.e. MSEC holdings and that the amount apportioned on daily capacity holdings did not include the daily holding after trades and buy backs.

Modification Proposal 0490a clarified that apportionment across daily holdings should be net daily position for a Shipper after trades and buy backs and that the amount apportioned nationally should also be on end-of-day capacity holdings (rather than just MSEC primary purchases).

Transco believes that the combined effects of the elements included within Modification Proposal 0490a will better promote cost targeting and hence would improve the operation of the regime without unduly increasing the complexity of regime operation or administration.

Additionally Transco believes adoption of Modification Proposal 0490a will generate much greater competition in the buy-back market where it will provide shippers holding unwanted capacity, on a day, with stronger incentives to sell it back to Transco thereby avoiding a share of the capacity buy-back costs that it would otherwise face via the current arrangements.

Transco notes that there is a risk of buy-back cost apportionment within the currently defined regime generating costs at terminals that are themselves not likely to be subject to significant levels of buy-back activity. Transco notes that implementation of Modification Proposal will reduce this commercial impact. Transco believes this an appropriate change to the commercial regime.

Transco believes that the current apportionment methodology was developed on the basis that capacity sales would be close to the physical capability of the system and hence the cost exposure would be modest and hence, given that it is not always possible to identify a particular “system constraint” against a particular ASEP, then the costs were apportioned on a “national” basis. Experience has already suggested that buy-back costs even in a regime with capacity sales close to physical capability have been considerable. Transco is conscious that both its modelling, and the views of shippers, imply much greater buy-back cost risk for this winter than was assumed for last.

Transco therefore believes that it is appropriate to amend the buy-back cost apportionment methodology. Transco is mindful of the fact that the proposal will target 50% of buy-back costs to the terminal at which the buy-back costs occur with the rest being apportioned on a national basis, and recognises that there is no analytical basis for the 50/50 split. However Transco believes that this a pragmatic move that is directionally appropriate. Such parameters may need to be reconsidered perhaps at the end of the winter period if similar cost apportionment processes continue to apply.

Transco also believes that the capacity incentive (particularly if Modification Proposal 0488 is implemented) will ensure that Transco is encouraged to take the most cost effective actions at whichever ASEP (or ASEP combination) is appropriate to address implied constraints if such action can be exercised across more than one ASEP.

On balance Transco believes that Modification Proposal 0490a represents an improvement to the regime to that which exists now and that which would exist if Modification Proposal 0490 was implemented. In particular, it should improve cost targeting and reduce the risk of distortions across ASEPs that might arise from the current cost allocation processes

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

Transco believes Modification 0490a removes any adverse impacts on bidding behaviour that might be created in the forthcoming auctions using the cost apportionment methodologies currently in place or proposed by Modification Proposal 0490 for the distribution of capacity buy back costs. Transco believes this better facilitates the relevant objective of "the efficient and economic operation by the licensee of its pipeline system" and "…the securing of effective competition between relevant shippers and between relevant suppliers" as laid out in standard condition 7(a) and 7(c) of Transco's PGT licence.

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

a) implications for the operation of the System:

No implications are envisaged for the operation of the System.

b) development and capital cost and operating cost implications:

No additional development and capital costs 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:

Transco does not anticipate that implementation of this Modification Proposal would create significant additional costs which it would seek to recover.

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

No consequences on price regulation arising from the implementation of Modification Proposal 0490a have been identified.

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 consequences on the level of contractual risk to Transco under the Network Code have been identified as a result of implementing Modification Proposal 0490a.

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

This change could be accommodated by the existing computer systems which would require some development work to enable the cost apportionment methodology defined in Modification Proposal 0490a to be implemented. Transco believes that such development might not be achievable, without risk, in time for the due date of the first invoice in November 2001. To this extent Transco proposes that computer systems be developed over time to allow for comprehensive testing. In the interim period Transco proposes to use the existing cost apportionment methodology to handle buy back costs and once new functionality is available to retrospectively redistribute costs to users on the basis outlined in Modification proposal 0490a. Transco anticipates this will be achieved by April 2002.

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

7. The implications of implementing the Modification Proposal for Users

Implementation of Modification Proposal 0490a may impact on the choice of bidding strategy adopted by Shippers for the forthcoming auctions. Some shippers may be exposed to some form of cashflow risk due to timing differences between the effective implementation date and the date by which systems changes would be ready to calculate the correct distribution of buy back costs.

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:

- Reduces cost exposure for those shippers that deliver gas to ASEPs that are unlikely to be the subject of buy backs
- Better targets costs to those ASEPs likely to be constrained
- Provides opportunity for shippers to avoid buy back cost exposure if they trade away their unused capacity on a day or have it bought back by Transco.

Disadvantages:

- The time available to Shippers to assess the impact of Modification Proposal 0490a on their bidding strategy for the auctions scheduled to take place on 29 August 2001 should Modification Proposal 0490a be implemented.
- The cashflow funding risk Shippers will be exposed to due to the timing differences between the availability of suitable billing systems and the effective date of implementation.

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

Representation have been received from the following parties :
Amerada Hess (Amerada)
Conoco (UK) ltd (Conoco)
Alliance Gas ltd (AGL)
BP Gas Marketing ltd (BP)
Exxon Mobil Gas Marketing (ExxonMobil)
Dynegy
Scottish & Southern Energy plc (SSE)
British Gas Trading (BGT)
BG Gas Services (BGGS)
Shell Gas Direct (Shell)
1 Confidential representation

Transco received 11 responses and note that 3 respondents (BG, BP, confidential response) supported proposal 0490a. Transco also notes that 3 supported at least some of the principles but did not advocate implementation because of the short notice period for the change prior to the auctions or to the short timescales associated with the consultation. Transco is mindful that 8 (Amerada, Conoco, AGL, ExxonMobil, Dynegy, SSE, BGT, Shell) respondents advocated that these proposals should not be implemented.

Amerada, Conoco, Dynegy, SSE, BGT, Shell express concerns about implementing any modification to the auction arrangements at such short notice. Amerada, Conoco, Dynegy add that a change of this magnitude needs to be debated fully prior to implementation and not rushed in days before the auction. AGL envisages that a more pragmatic approach would be to suspend the existing incentive mechanism pending further industry discussions.

SSE expressed grave concerns over the proposals extremely short timescales and believes that it constitutes an abuse of the urgent modification process.

BGT states that there is insufficient time to fully review the process and Transco's incentive scheme before the auction. It believes that Modification Proposals 0488, 0489 and 0490 as well as PC65 and PC66 should undergo a thorough review prior to the next capacity allocation taking place in April 2002. BGT add that it has concerns that continued delays and uncertainty could result in violent corrections to the forward curve, once outcomes are known, resulting in price distortion effects.

BGGS expresses disappointment that there has not been more time for this Modification to be properly discussed and would, subject to the acceptance of modification 0489, welcome an extension to the consultation period to Wednesday 29 August.

Dynegy acknowledges that the proposal has features that may further Transco’s relevant objectives by targeting cost at those ASEP terminals able to sell back capacity and aiding a liquid secondary market.

AGL does not support the proposal on the basis that it may fundamentally change both Transco and shipper behaviour both in relation to auctions and on a daily basis.

BP expresses support for the proposal stating that it apportions capacity incentive costs across all types of capacity holdings and not just MSEC holders across all terminals. BP adds that it would consider the most appropriate way for the industry to address the issue of buyback costs is via the alternative method of funding entry capacity constraints as put forward in PC65.

Dynegy observe that Modification Proposal 0481 raises the potential for high cost for capacity buybacks. It suggests that though the extent to which this will occur is questionable, it is plausible that the regime faces greater risk of capacity buybacks. Dynegy therefore considers that these proposals seek to redress the liability for paying for buybacks, and therefore will have a serious effect on potential liabilities and bidding strategies that may again need to be revised.

BGGS suggest that the effect of the implementation of Modification 0481 has significantly increased the likelihood of within day buy back costs and that under the current regime this is the worst method of cost redistribution. BGGS suggest that its proposal would see the Relevant Capacity Costs being apportioned against a shipper's effective capacity holdings on a daily basis, as opposed to firm monthly capacity holders.

ExxonMobil notes that in respect of Transportation Constraints the Network Code definition refers to 'System' rather than 'terminal'. It suggests that it may not be clear that the particular constraint is attributable to a specific terminal. This would be particularly true for the 'Northern Triangle'. Exxon Mobil view that the apportionment of cost across all MSEC holders, per current regime, appears to be consistent. BGT and SSE highlight that during the debates prior to the introduction of the auction in 1999 it was widely accepted that the integrated nature of the NTS network means that constraints at a particular terminal might be due to circumstance on other points of the system. SSE considers it inappropriate to target buyback cost to shippers at constrained terminals. Shell observes that 'Constrained ASEP' is not a term specifically defined in this proposal or in the Network Code and questions how this definition would work in practice.

BGGS also notes that the Network Code defines constraints at System level rather than a particular ASEP, but the effect of the 'System' constraint is that it is only available at the terminal where Transco require capacity surrender.

ExxonMobil observes that the proposal states that the current capacity incentive mechanism is discriminatory and may distort the bidding behaviour in the primary auction'. ExxonMobil suggests that the proposal itself apportions a higher proportion of buyback cost to terminals where Users surrender capacity equally leading Users to pay a multiple of their bid prices.

BGT believes that these modifications incentivise shippers to minimise their capacity holdings to such an extent that capacity requirements may not be adequately covered in the primary auctions, and this may have the effect that system security is compromised. BGT adds that shippers should be in a position to use the most economic gas and capacity combination to choose where to land gas, otherwise efficient demand signals cannot be given and there will be a consequential impact on the price of gas at the NBP. BGT considers that this may result in potential primary rationing. BGT concludes that this may lead to Transco having both control and discretion over where shippers can land their gas in the system, thus causing extreme price volatility in the prompt market.

BGT suggests that these Modification Proposals will push the auction to an under recovery and will distort cost through the recovery mechanism.

BGGS notes that the effect of existing Network Code rules is that there is now a significant commercial disadvantage in holding firm monthly entry capacity, particularly during shoulder months and suggests that this is counter to the argument of holding the monthly capacity auctions. BGGS highlight that Ofgem are keen that all available capacity is released by Transco. Shippers need capacity to bring gas in and yet may be penalised by the buyback cost that is now be anticipated. BGGS noted that most of this cost will occur in the shoulder months.

BGGS includes in its response calculations which demonstrate the effect of buyback cost across the ASEPs and shipper holdings. It suggests that there will be low revenue recovery and monthly buyback costs that could exceed Transco's revenue. Additionally it provides direct cross subsidy from unconstrained to constrained shippers.

BGGS states that it is inappropriate to target buyback costs against all entry capacity at the constrained terminal as it is often constrained interruptible capacity that gets offered back to Transco. It suggests that as a consequence of Transco being unable to link capacity and gas flows together, Transco usually has to buyback all capacity down to the marginal effective therms.

SSE notes that it is uncertain how the proposals will operate in the event that modification proposal 0488 is implemented.

SSE and BGGS observe that the conclusions of Ofgem's buyback investigation is yet to be published which is regrettable. SSE suggests that the outcome may have a bearing on behaviour in the buyback market this winter and may negate the perceived need to change the buyback regime.

In summary BGGS state that it prefers the Transco alternative proposal in that it treats all capacity more fairly. It notes an additional benefit of the modification is that it discourages the hoarding of entry capacity or the potentials windfall gains from zero cost interruptible entry capacity by nonphysical players.

Transco’s Response

Transco is sympathetic to concerns arising from the timing of these Modification Proposals given the close proximity of the impending auctions on 29 August but believes that timing alone cannot be a reason for the recommendation or rejection of any Modification Proposal. Transco believes that these Modification Proposals need to be assessed on the degree to which they better facilitate the relevant objectives as outlined in Transco’s PGT licence. To the extent that Transco believes either of the Modification Proposals achieve this, then Transco will recommend implementation. Ultimately the direction to implement, or otherwise, rests with the Gas and Electricity Markets Authority which will have to reach a view as to the degree to which timing may impact on facilitation of the relevant objectives.

One shipper (BGT) noted that the proposal “incentivises shippers to minimise their capacity holdings to such an extent that capacity requirements may not be adequately covered in the primary auctions, this could have the effect that system security is compromised.”

Transco’s view is that the current defined rules could be even worse with respect to the primary allocation of MSEC given that after purchasing MSEC shippers would currently be unable, by the subsequent trading of capacity (either to other shippers or back to Transco) to mitigate their exposure to buy-back cost apportionment. This is particularly true at ASEPs that are not likely to be subject to buy-backs and which might be expected to provide easy access for more flexible gas supplies to ensure the safety and security of the system.

Implementation of the proposal would improve the position in respect of this issue by reducing the disincentive to hold MSEC which Transco believes will better ensure the safety and integrity of the system.

One shipper (BGT) also believes that as “a result of the potential primary rationing, Transco would have both control and discretion over where Shippers can land their gas in the system, thus causing extreme price volatility in the prompt market. The market, through buybacks and gas prices, should decide the most efficient was (sic) of landing gas”.

Transco believes that this proposal will help address the concern that this shipper has in respect of primary rationing by reducing the potential disincentive to hold capacity at some ASEPs. Additionally it should be expected that if MSEC purchases are low then Transco would be encouraged to market within-day firm capacity in considerable quantities in response to shipper bidding. Under the scenario portrayed by this shipper it is likely that there would be far greater liquidity (at least in respect of within day firm capacity demand) which could generate significant efficiencies in the prompt. The market would be able to consider the most efficient way to beach gas taking account of incremental within day firm capacity values, buyback and gas prices. Effectively shippers would need to consider the administrative costs associated with daily capacity transactions compared to the relative ease of MSEC capacity administration taking account of the buy-back cost apportionment exposure.

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

Implementation of this Modification 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 3(5) or the statement furnished by Transco under Standard Condition 3(1) of the Licence

Implementation is not required as a consequence of any proposed change in the methodology established under Standard Condition 3(5) of the statement furnished by Transco under Standard Condition 3(1) of the Licence.

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

Transco has undertaken a preliminary assessment and believes implementation of necessary billing systems changes, as detailed in section 6, would need to be achieved between now and April 2002.

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

Transco proposes that this Modification Proposal is implemented on 1 October 2001.

16. Recommendation concerning the implementation of the Modification Proposal

While Transco recognises the real concerns about the timescales involved, the Modification Rules allow for Urgent Procedures in order to allow rapid implementation of Modifications which better facilitate the relevant objectives where time is of the essence. Transco therefore believes that recommending implementation is in line with its obligations and hence recommends implementation of Modification Proposal 0490a.

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.

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 recommendation to implement the alternative proposal to amend the Network Code accordingly and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

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

Draft: 23 August 2001
DBT/TEMP.TEMP/5393498.01

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Draft 1.0: 24 August 2000

MODIFICATION [0490A]

ADJUSTMENT TO ASEP CAPACITY REVENUE NEUTRALITY CALCULATION

[Draft] proposed legal text Text assumes Modification 0488 implemented and effective.

Section S amendments yet to be addressed.

TRANSITION DOCUMENT PART II

At paragraph 8.1.11 delete text at paragraph (3)(b) and insert text to read as follows:

"(b) in relation to each Aggregate System Entry Point, each relevant daily User shall pay to Transco an amount ("**Capacity Cost Neutrality Charge**") determined as:

$$((RCC / 2) * (UEC / AUEC)) + ((RCC / 2) * (UAEC / AAEC))$$

where [(in each case for the relevant Day)]:

RCC are the Relevant Capacity Costs; BR's refer to 'Capacity Incentive Costs' – assume that in line with Modification 0488 100% of costs be borne by Shippers.

UEC is the User's Fully Adjusted Available System Entry Capacity;

AUEC is the aggregate of all Users' Fully Adjusted Available System Entry Capacity;

UAEC is the User's aggregate Fully Adjusted Available System Entry Capacity at all Aggregate System Entry Points; and

AAEC is the aggregate of all Users' Fully Adjusted Available System Entry Capacity at all Aggregate System Entry Points;"

Amend paragraph 8.1.11 paragraph (15) to read as follows:

"(15) ….for the relevant Month <u>and a "**relevant daily**" User is a User holding Available System</u>

<u>Entry Capacity at an Aggregate System Entry Point on the relevant Day in the relevant Month</u>;"

Text assumes Modification 0488 implemented and effective.

Section S amendments yet to be addressed.

BR's refer to 'Capacity Incentive Costs' – assume that in line with Modification 0488 100% of costs be borne by Shippers

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 **0490**, version **1.0** dated **24/08/2001**) 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 **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 <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.