URGENT Modification Report
Redesign of Capacity Incentive Regime
Modification Reference Number 0488

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 major changes to the structure of Transco's capacity incentive and the nature of any shipper share buyback costs may affect a shipper's valuation of capacity in the monthly auctions. Any changes to the incentive parameters resulting from the proposal will therefore need to be made prior to the commencement of auctions on 29 August 2001 that cover the period 1 October 2001 to 31 March 2002 are scheduled to commence on 29 August 2001. Provision of urgent status should provide shippers sufficient time 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	16 August 2001
Proposal agreed as Urgent	17 August 2001
Proposal issued for consultation	17 August 2001
Close out for representations	22 August 2001
Final Report to Ofgem	23 August 2001
Ofgem Decision expected	24 August 2001

1. The Modification Proposal

The proposal was to separate the current capacity incentive from capacity neutrality and introduce a new capacity incentive independent of capacity neutrality.The capacity buyback costs and any incremental sales revenue will continue to be redistributed via current capacity neutrality arrangements but the current capacity incentive that is structurally embedded within capacity neutrality will be disabled. This will result in 100% of the capacity buyback costs and 100% of incremental sales revenue accruing to Shippers.

A new capacity incentive will be introduced under which Transco's Capacity Incentive Performance Measure (CIPM) is based on the net cost (or revenue) of actual costs of capacity buy backs and incremental sales revenue for a month compared to an ex-ante forecast of the same. Where CIPM is equal to zero (i.e. actual net costs are equal to forecast) Transco will face no reward or penalty. Superior performance occurs when actual costs are lower than the forecast and inferior performance occurs when actual costs exceed the forecast level.

The level of forecast costs is expected to be a function of the physical capability of the system, the cost of buy backs, revenue from incremental sales, supply pattern preference and the level of firm capacity sold. Based on its analysis of buy back costs and incremental sales Transco suggests that, for the expected value of CIPM to equal zero, forecast costs should be set at £10m per month over the six month period commencing on 1 October 2001 (representing one sixth of the forecast mean costs over the six months).

To mitigate the significantly greater uncertainty associated with buy back costs resulting from Modification Proposal 0481, Transco proposes that its maximum potential risk and reward be reduced to half their present values, leading to a cap and collar of +/- £208k per month. This would limit the potential financial impact on both shippers and Transco arising from the increased uncertainty present within the revised regime.

Transco's analysis indicates a 90% confidence interval for forecast costs of £24m to £113m over the forthcoming six-month capacity period. Transco proposes that under the new incentive, the monthly cap and collar should be consistent with this confidence interval, and hence be one sixth of the lower (£4.0m) and upper (£18.8m) ends of this range respectively. This would ensure that Transco continued to have a direct financial incentive to minimise buyback costs, and maximise revenue from capacity sales, over a wide range of scenarios. Transco's share of any cost or reward would be calculated based on linear interpolation from the mid point (£10m per month) to the cap or collar respectively.

If actual costs are greater than those forecast then performance is inferior and aggregate payments will be made by Transco to shippers. If actual costs are less than those forecast then performance is superior and aggregate reward will be paid by shippers to Transco.

The proposed apportionment methodology will be the same for distributing both the revenues and costs arising from the new capacity incentive. The apportionment methodology of capacity incentive revenues and costs will be in proportion to the sum of each shippers MSEC capacity holdings across all ASEPs for that month, divided by the sum of all MSEC capacity holdings for all Users across all ASEPs for that month which is consistent with the current method of sharing daily capacity costs.

It is intended for this revision to the capacity incentive to exist to cover the period 1 October 2001 to 31 March 2002.

2. Transco’s Opinion

Transco's current capacity incentive rewards Transco for release of additional capacity and penalises it for capacity buybacks; it therefore incentivises Transco to optimise buybacks and sales.

Implementation of Modification Proposal 0481 is likely to adversely skew the expected outcome of the current incentive. Consequently, Transco would have very limited expectation of any upside under the current incentive and might reasonably expect increased downside exposure. Indeed the change might be expected to effectively eliminate the incentive on Transco.

This Modification Proposal seeks to rebalance the risk/reward distortion resulting from Modification Proposal 0481, and thereby effectively to reintroduce appropriate risk/reward incentive for Transco.

In the light of representations, Transco proposes to retain its existing maximum potential risk and reward of +/- £416k per month. Transco further proposes that its revised incentive should be consistent with the 80% confidence interval which it estimates at £30m to £100m, rather than the 90% confidence interval originally proposed. Hence the monthly cap and collar will be one sixth of the lower (£5m) and upper (£16.7m) ends of this range respectively. These changes will have the effect of increasing Transco's share of any cost or reward compared with the initial Proposal.

Implementation of this Proposal will ensure that Transco's incentive continues to be based on an appropriate risk and reward. Consequently, Transco will continue to be incentivised to reduce buyback costs.

If this Proposal is not implemented, Transco's capacity incentive may effectively turn into a cost implied by the current incentive monthly collar, effectively eliminating the financial incentive that the NGTA capacity regime was designed to deliver.

It is therefore Transco's opinion that this Proposal should be implemented at the earliest opportunity, and no later than the commencement of auctions scheduled to take place on 29 August 2001.

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

Transco believes that a financial incentive linked to costs will continue to directly incentivise Transco to operate the short term capacity mechanisms efficiently. This will facilitate the "efficient and economic operation by the licensee of its pipeline system", as stated in the Standard Condition 7 of its PGT licence.

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.

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:

This Proposal would not have any consequential impact on price regulation.

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

It is not envisaged that implementation of this Modification Proposal would significantly reduce increase the level of contractual risk to Transco under the Network Code, arising from the implementation of Modification Proposal 0481.

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

This change could be accommodated using existing computer systems with minor enhancements. Therefore, any development work would be small and achievable within the desired timescale.

Transco is not aware of any impact on Users' computer systems.

7. The implications of implementing the Modification Proposal for Users

Disablement of the current capacity incentive will result in 100% of the capacity buyback costs and 100% of incremental sales revenue accruing to Shippers and redistributioned via current capacity neutrality arrangements. It is intended to use existing invoices on which capacity neutrality charges (including incentive payments/receipts) currently exist. This ought to minimise the impact of changes arising from implementation of this Modification Proposal on Users' systems.

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

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

Advantages:

- This approach avoids the need for a fighting fund since all costs are dealt with through neutrality (similar to energy balancing)
- Systems changes would be simple and achievable within the timescales available
- Maintains a balanced risk/reward incentive

Disadvantages:

- No disadvantages have been identified.

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

Representations were received from 15 shippers (one of which is confidential):

Amerada
Northern Electric and Gas Limited (NEAGL)
Alliance Gas Limited (AGL)
BP Gas Marketing Limited
British Gas Trading (BGT)
ExxonMobil Gas Marketing
Scottish and Southern Energy plc (SSE)
Chevron UK Limited
BG Group plc
Scottish Power
Shell Gas Direct Limited
CONOCO (UK) Limited
POWERGEN
TotalFinaElf

All respondents recognised the impact of Modification Proposal 0481 on the capacity incentive mechanism. The majority of the respondents also sympathised with Transco because of the adverse impact on the current incentive mechanism. However, almost all the respondents raised concerns about the parameters proposed by Transco and considered the timescales for consultation to be too short. None of the respondents supported the Proposal in its current form.

Amerada is concerned that this Proposal is too close to the winter auctions and changes the fundamentals on which shippers will value capacity. It requests clarification of the way Transco intends to derive its ‘ex-ante forecast of potential costs.

NEAGL agrees with Transco that, in light of implementation of Modification Proposal 0481, the current Capacity Incentive needs to be revisited but it has a number of reservations about Modification Proposal 0488. NEAGL does not believe that it addresses asymmetrical treatment of within day sales and buybacks and redistribution of buyback costs on a non-ASEP specific basis. It considers that Transco’s proposal to remove itself from the current cost/revenue sharing arrangements is against the intended spirit of the Capacity Incentive. NEAGL is disappointed with the short timescales for this Proposal and the lack of information on Transco’s forecast level of buyback costs. It believes that the forecast buyback costs have been ‘over-forecast’ compared with those for the last winter but could in fact be lower as a consequence of a surplus of capacity that Transco could buyback at ‘reasonable’ capacity surrender prices. NEAGL strongly believes that incentive parameters should be defined within the Licence so that it does not lead to the perverse situation of Transco suggesting its own incentive parameters. NEAGL also urges Ofgem to make a timely decision so that shippers are not exposed to further regulatory risk.

AGL understands and sympathises with the lack of potential reward under Transco’s existing capacity incentive following the implementation of Modification Proposal 0481. However, it is concerned that Modification Proposal 0488 significantly reduces Transco's incentive to manage constraints in the most efficient manner. It is also concerned that the proposed level of forecast buyback costs has not been discussed with the industry. AGL believes that the forecast level may not be meaningful as it ignores variables such as shipper strategies for pricing buyback offers. AGL suggests that, as an interim measure, a pragmatic approach might be to either suspend the existing incentive mechanism pending further industry discussions or simply reduce the current monthly revenue exposure to Transco.

BP expresses disappointment at the short timescales for responses and a lack of a decision on PC65 that, in BP's opinion, is a viable alternative method of funding entry capacity constraints. It sympathises with Transco regarding the adverse impact of Modification Proposal 0481 on Transco's capacity incentive and is willing to see discussions on development of a symmetrical risk/reward incentive. However, it is concerned that the 90% confidence range of £24m-£113m for forecast buyback costs is considerable and Transco's cap and collar should be revised prior to its application. BP is also concerned that the estimate of buyback costs is an unknown quantity to both Transco and shippers and has the potential to be inaccurate or overstated; it also questions the same forecast value of £10m for all months. BP recommends that a more appropriate incentive mechanism should be developed, to coincide with the long term auctions in 2002.

BGT believes that this Proposal is too close to the forthcoming capacity auctions to carry out a thorough review of Transco's incentive scheme, and that there is not sufficient time for industry discussion and agreement. It also believes that the other outstanding issues (pricing consultations PC65 and 66, and Modification Proposal 0486) should be resolved prior to the design of the capacity incentive. BGT suggests that the basis of forecast costs should be transparent and should be agreed by the industry before the auctions but the actual forecast costs should be set after the results of the auctions are known. It considers the average monthly forecast value of £10m to be very high and unlikely to be the same for every month; in at least one month, the capacity offered during the auctions will be identical to the ASEP maximum, and as such, the forecast should be equal to zero. BGT believes that the additional risk to Transco is just over 15,300GWh (around 525 mth) and, for an overall cost of £60million over the six-month period, this capacity would have to be sold back at around 12p/th. BGT considers this to be completely unrealistic. BGT expresses disappointment at changes being made at such a late stage that could potentially increase players' uncertainty and price volatility.

ExxonMobil agrees with Transco that a financial incentive linked to costs will continue to directly incentivise Transco to operate the short term capacity mechanisms efficiently. ExxonMobil believes that lack of assumptions and calculations in forecasting buyback costs of £24m to £113m, makes it impossible to assess the validity of these forecasts. It also considers that the monthly forecast buyback costs should be consistent with the level of MSEC release versus Transco stated maximum physical i.e. they should vary from month to month, rather than equal apportionment of £60m across the six-month period. ExxonMobil sees no justification for reducing the current cap and collar from £416k to £208k. It believes that there could be an upside under the current incentive if there were unsold capacity in the monthly auctions. ExxonMobil suggests that any proposed redesign of the capacity incentive should only be put forward after industry discussion so that a more transparent and fully understood proposal may be developed.

SSE appreciates Transco's concerns about the adverse impact on its capacity incentive but does not consider this to be an issue until the outcome of the forthcoming auctions is known. SSE has not been able to fully consider the implications of this Proposal because of short timescales and believes that this Proposal, just one week prior to the commencement of auctions, could create uncertainty. SSE's primary concern is that the proposed incentive is based on Transco's own forecasts of net costs and revenues and shippers are not in a position to assess its accuracy or reliability; inaccurate forecast costs could lead to further modification proposals. SSE believes that, since more capacity is being offered, the buyback market ought to be more liquid and hence the buyback prices and resulting buyback costs should be lower. SSE believes that Transco would only be incentivised to reach its forecasts rather than minimise the actual costs of buyback. It sees no reason for Transco's risk/reward to be half of the current level, or to net off costs and revenue. It also points out that, due to the Bank Holiday on Monday 27 August 2001, shippers might only have one day to determine their bidding strategy, which is clearly unacceptable. SSE does not believe that last minute changes to the auction fundamentals are conducive to stability in the regime.

Chevron believes that Transco must retain a significant incentive to maximise capacity available on the day. Chevron believes that capacity constraint problems are likely to be more profound in the 'shoulder months' of October, November and March. Furthermore, during these months, Transco may be compounding the shoulder capacity by performing compressor work at Aberdeen and Kirrimuir. Whilst Chevron questions the timing of compressor work, it believes that, in the short term, Transco needs to be incentivised to complete any maintenance work in a timely manner. It suggests that the additional capacity from the new pipeline between St Fergus and Aberdeen should be made available as soon as safely practicable. Furthermore, Transco should make this additional capacity public so that bidders can take this into account when planning their auction strategies.

BG would welcome a stop-gap solution for the forthcoming auctions and points out that it has submitted an Urgent Modification to this effect. It expresses concerns at the short timescales for consultation. It is also unclear about the interaction of this Proposal with PC65 that is still awaiting commentary from Transco and Ofgem. Whilst BG sympathises with Transco's increased risk exposure, it is disappointed that its Proposal does not address the primary inefficiency that lies in the overall neutrality mechanism. BG is particularly concerned about Transco's behaviour regarding release of additional capacity and interruptions, which might worsen under this Proposal. BG states that, in the shoulder months, Transco's risk exposure is likely to be less than the 20% under the current incentive, and Transco may become indifferent to the prices at which they take buyback action. BG would welcome the publication of Ofgem's investigation into last October's buyback activities as this might provide further clarity. BG cites excessive risk exposure for firm capacity holders at unconstrained ASEPs as the main reason for submitting its own Urgent Modification Proposal.

Scottish Power expresses concerns about short timescales, but sympathises with Transco in seeking to reflect changing circumstances via a change to the capacity incentives. It agrees that there is an increased likelihood, but not certainty, of an increased level of buyback activity over the winter period, and that Transco would like to have the desired modifications in effect before 1 October. Scottish Power is interested in limiting shipper exposure but believes that this Proposal does not achieve this. Whilst it acknowledges the position Transco has been put in by the implementation of Modification Proposal 0481, it believes that the industry has not had sufficient information or discussion on the proposed approach. It also has reservations about an average monthly forecast, due to significant monthly variations, and points out that October 2000-December 2000 buyback exposure was significantly different from January 2001-March 2001. Scottish Power acknowledge that there is a need to change Transco’s capacity incentive but does not support the disabling of the current arrangements.

Shell Gas Direct is not convinced that Transco’s capacity incentive needs to be changed in response to the changes introduced by Modification Proposal 0481. It believes that Transco will be able to raise revenues through the UIOLI provisions, daily capacity and the potential for all capacity not to be sold thus releasing of additional capacity in the daily market. Shell Gas direct would have welcomed further information on the monthly forecast level of buyback costs as it is uncertain as to the extent selling capacity rights have influenced these figures. It believes that the Proposal has the potential for significant upside to Transco, and the distribution of costs for each month is likely to be skewed. Shell Gas Direct expresses concerns regarding continuing uncertainty associated with the auctions and its adverse impact on the efficient operation of the gas pipeline system and associated markets.

Confidential response states that the Proposal transfers risk from Transco to shippers and does not adequately deal with the allocation of buyback costs. Whilst Transco may lose money under the current incentive, the proposed solution only seeks to reduce this risk by exposing shippers to a higher level of buyback costs. It believes that a more appropriate response is an incentive mechanism that produces similar levels of revenues and costs to the current arrangements. It also believes that the monthly forecast level should be profiled to be more effective. It is disappointed that Transco has not dealt with the inequitable allocation of buyback costs and may be encouraging higher buybacks than are absolutely necessary. It points out that this Proposal also demonstrates the problem of rushing through policy changes at short notice, creating uncertainty in the lead up to the auctions. Whilst it believes that the underlying concept of the Proposal is reasonable, it believes that more time is needed to consider shipper concerns and ensure robustness of the incentive design.

CONOCO does not believe that the increased probability of buyback necessarily changes Transco’s position in terms of risk. It also states that proposed figures are based on information that is not readily available and uses methodologies that are not transparent. Whilst it agrees that the regime has become skewed, it also notes that the previous regime was skewed in Transco’s favour and Transco had made little effort to equalise the imbalance. It also points out that even if all available MSEC were sold out, the initial volumes would represent capacity that is unused and hence could be bought back at competitive prices. CONOCO does not believe that Transco should be allowed to dictate the level of its incentive, based on its own forecasts and estimations. CONOCO considers the risk to shippers and the timing of Proposal to be unacceptable, allowing very little time for thorough consideration of issues whilst simultaneously forming bidding strategies.

POWERGEN questions the credibility of Transco's forecast costs of £10m per month, as this figure seems high and the volumes being sold under Modification Proposal 0481 vary enormously from month to month. It also questions implementation of Modification Proposal 0488 for six months only. POWERGEN is also unclear on the 90% confidence levels. It points out that this Proposal, suggesting the likelihood of increased buybacks, is inconsistent with PC66 that predicts an under-recovery in the next auction, leading to lower cost of capacity and hence lower buyback costs. It does not find introduction of a major change in the run up to the next capacity auction helpful. Whilst it agrees that it is sensible to separate the capacity neutrality from the capacity incentive and reduction in Transco's cap and collar to £208,000, it does not believe that arbitrary nature of forecast costs is the solution.

TotalFinaElf recognises the need for further consideration of the appropriate capacity incentive mechanism but believes that this Proposal does not achieve the appropriate balance between risk and reward, and may in fact introduce perversities into the capacity incentive regime. The monthly forecast figure of £10m for buyback costs can not be verified independently and is unlikely to be fixed over a month or a season. TFE believes that this Proposal incentivises Transco to overestimate buyback costs and then reward it by consistently achieving its targets under the proposed incentive. TFE would prefer establishment of CPIM following independent scrutiny and consultation with the industry and Ofgem.

Transco's opinion:

Transco agrees that the short time afforded to this Proposal is challenging but believes that sufficient time has been allowed for shippers to give a considered response and to account for the impact it might have on their participation in the forthcoming auctions. The timing of auctions and their impact on bidding strategies and capacity incentive were precisely the reasons that led Transco to raise this Proposal as Urgent. Transco wanted to make sure that both Users and Transco had the opportunity to assess risk implications for their respective businesses prior to the commencement of auctions.

With regard to the forecast buyback costs, Transco agrees with respondents that likely costs are highly uncertain. In deriving projections, Transco has taken several factors into consideration, including physical capability of the system, the level of firm capacity potentially sold, supply pattern preference, previous experience of the cost of buybacks and revenue from incremental sales. Transco recognises that there may be other factors that could have a direct impact on the forecast buyback costs; for example, the 'top-down' approach for release of capacity may influence Users' behaviour regarding capacity buyback offers. However, Transco is not in a position to predict the impact of such factors, and has therefore derived the forecast buyback levels by considering the best information it has access to. Inevitably, the possible cashflows associated with incremental sales and buybacks cover a wide range reflecting the considerable uncertainties associated with both volume and price. The parameters have been set assuming a wide confidence interval that should ensure a high probability of the incentive remaining active.

However, in response to shipper concerns about the potential diminution of incentives, Transco proposes to retain monthly caps and collars at the present level rather than the reduction suggested in the initial Proposal. This would have the effect of doubling the sharing factors within the Proposal. In addition, Transco proposes to narrow the range slightly over which the revised incentive would operate compared with the initial Proposal. This effectively further increases the sharing factors. Specifically, Transco proposes to adopt the 80% confidence interval as the range for the incentive performance measure. Transco believes that this achieves an appropriate balance between the desirability of having a wide range of outcomes covered by the incentive, and a sufficient level of sharing factor to provide a meaningful incentive within this range.

Transco understands shippers' concerns over the proposal to have the same target cost level for each month. In putting forward this proposal, Transco has been mindful of the objective to depart from its present incentive structure only where necessary in order to attempt to recreate the present scheme's characteristics. Equal monthly caps and collars are a feature of the present regime.

Transco recognises concerns over the lack of transparency associated with the modeling underpinning this proposal. Transco notes, however, that Ofgem has access to its model and has been made fully aware of the assumptions employed.

Prior to raising this Proposal, Transco also considered the alternative of revising the parameters in the current capacity incentive. Whilst this option might reduce Transco's risk (e.g. by reducing the monthly collar), a parameter change to Transco's reward would not have any material effect as the likelihood of any reward is very low and, indeed, the reward side may not be triggered. This option might superficially result in a symmetrical risk/reward incentive but would in practice remain biased towards a financial loss. Transco does not believe this is consistent with a 'fair' incentive.

This Proposal is intended to revise the current capacity incentive in order to readdress the risk/reward distortion as a consequence of implementing Modification Proposal 0481. Whilst the Proposal changes the revenue/cost sharing arrangements between shippers and Transco from "80:20" split to "100:0", it does not seek to revise the existing principles of capacity neutrality such as ASEP-specific distribution of revenue and non-ASEP-specific distribution of costs. It merely specifies a single driver for the treatment of incentive revenues and costs.

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

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

No modifications are required to the UK-Link Systems and therefore a programme of work would not be required as a result of implementing the Modification Proposal.

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

Transco recommends that this Modification Proposal be implemented.

Transco recognises that this Proposal is only effective for six months but believes that its implementation is necessary to address increased risk exposure to Transco following implementation of Modification Proposal 0481. Transco notes that, whilst respondents raised concerns about the parameters proposed by Transco and the short timescales for consultation, the majority of the respondents were sympathetic to Transco’s position and did agree that a revision to the current capacity incentive may be appropriate.

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

TRANSITIONAL DOCUMENT PART II

Add new paragraph 8.1.11 to read as follows:

"B2.13 In respect of the calendar months October 2001 to March 2002 (inclusive) (each a "**relevant Month**"):

(1) without prejudice to paragraph (11) below and the continued application of Section B2.13 during the relevant Months in respect of calendar months preceding October 2001, Section B2.13 shall not apply and the arrangements set out in paragraphs (2) to (6) below shall apply, such that the difference between amounts received or receivable and paid or payable by Transco in respect of Relevant Capacity Charges and certain other amounts in each relevant Month shall be payable to or recoverable from relevant Users (and such amount shall not be reduced by any amount to be retained or borne by Transco);

(2) for each Aggregate System Entry Point:

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

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

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

in respect of Days in that relevant Month;

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

(3) in relation to:

(a) each Aggregate System Entry Point, Transco shall pay to each relevant User an amount ("**Capacity Revenue Neutrality Charge**") determined as:

(i) where one or more Users hold Registered Monthly System Entry Capacity at the Aggregate System Entry Point in relation to that relevant Month:

$$RCR * URC / ARC$$

where:

RCR is the Relevant Capacity Revenues;

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

ARC is the aggregate of all Users' Registered Monthly System Entry Capacity,

for that Aggregate System Entry Point in relation to that relevant Month;

(ii) where no User holds Registered Monthly System Entry Capacity at the Aggregate System Entry Point in relation to that relevant Month:

RCR * AURC / AARC

where:

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

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

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

(b) each relevant User shall pay to Transco an amount ("**Capacity Cost Neutrality Charge**") determined as:

RCC * AURC / AARC

where:

RCC are the Relevant Capacity Costs;

and 'AURC’ and 'AARC' have the meanings in paragraph (a) above, for all Aggregate System Entry Points in relation to that relevant Month;

(4) the "**Capacity Adjustment Neutrality Amount**" for the relevant Month (month 'm') is:

(a) the sum of:

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

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

less

(b) the sum of:

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

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

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

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

(5) "**Capacity Neutrality Charges**" comprise Capacity Revenue Neutrality Charges, Capacity Cost Neutrality Charges, Capacity Adjustment Neutrality Charges and User Monthly Capacity Incentive Amounts;

(6) where:

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

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

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

$$CNAA \quad * \quad AURC \ / \ AARC$$

where CNAA is the Capacity Neutrality Adjustment Amount and 'AURC' and 'AARC' have the meanings in paragraph (3)(a)(ii) above;

(7) pursuant to the arrangements set out in paragraphs (8) to (14), Transco will pay or be paid certain amounts to or by relevant Users in respect of each relevant Month by reference to the amount by which the Actual Capacity Amount differs from the Forecast Capacity Amount (the "**Revised Capacity Incentive Arrangement**");

(8) for the purposes of the Revised Capacity Incentive Arrangement for each relevant Month:

(a) the "**Capacity Incentive Performance Amount**" is the Actual Capacity Amount less the Forecast Capacity Amount;

(b) the "**Actual Capacity Amount**" is Relevant Capacity Costs less Relevant Capacity Revenues;

(c) the "**Forecast Capacity Amount**" is £10,000,000 (being a positive amount);

(d) the "**Lower Forecast Capacity Amount**" is £5,000,000 (being a positive amount);

(e) the "**Upper Forecast Capacity Amount**" is £16,700,000 (being a positive amount); and

(f) the "**Maximum Capacity Incentive Amount**" is, in respect of both superior performance and inferior performance, £416,000 (being in each case a positive amount);

(9) in relation to the Revised Capacity Incentive Arrangement, for any relevant Month, Transco's performance:

(a) is 'superior' where the Actual Capacity Amount is less than the Forecast Capacity Amount; and

(b) is 'inferior' where the Actual Capacity Amount is greater than the Forecast Capacity Amount;

(10) for each relevant Month the "**Relevant Monthly Capacity Incentive Amount**" is:

(a) where Transco's performance was superior, the amount determined as the lesser of:

(i) £416,000; and

(ii) MCIA * (CIPA / (FCA - LFCA));

(b) where Transco's performance was inferior, the amount determined as the lesser of:

(i) £416,000; and

(ii) MCIA * (CIPA / (UFCA - FCA));

(c) where the Capacity Incentive Performance Amount is zero, zero; and

where

MCIA is the Maximum Capacity Incentive Amount;

CIPA is the Capacity Incentive Performance Amount;

FCA is the Forecast Capacity Amount;

LFCA is the Lower Forecast Capacity Amount; and

UFCA is the Upper Forecast Capacity Amount;

(11) for the purposes of calculating the Actual Capacity Amount no account shall be taken of Relevant Capacity Costs incurred by Transco in the circumstances referred to in Section B2.13.4;

(12) in respect of each relevant Month for which performance was:

(a) superior, each relevant User shall pay Transco the User Monthly Capacity Incentive Amount; and

(b) inferior, Transco shall pay each relevant User the User Monthly Capacity Incentive Amount;

(13) for each relevant User for each relevant Month, the "**User Monthly Capacity Incentive Amount**" is the Relevant Monthly Capacity Incentive Amount multiplied by the User Capacity Incentive Proportion for that relevant Month;

(14) the "**User Capacity Incentive Proportion**" for a relevant Month is the aggregate of the relevant User's Registered Monthly System Entry Capacity at all Aggregate System Entry Points for the relevant Month divided by the aggregate of all relevant Users Registered Monthly System Entry Capacity at all Aggregate System Entry Points for the relevant Month (provided that in the event that no Monthly System Entry Capacity was held by any User at any Aggregate System Entry Point for the relevant Month, 'AURC' and 'AARC' will be determined on the basis of the most recent calendar month in respect of which a User held Monthly System Entry Capacity at an Aggregate System Entry Point);

(15) for the purposes of this paragraph 8.1.11 a "**relevant User**" is a User registered as holding Monthly System Entry Capacity at an Aggregate System Entry Point for the relevant Month;

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

(17) Capacity Neutrality Charges shall be invoiced and payable in accordance with Section S (provided that an Invoice Document may specify an earlier Billing Period for the purposes of showing User Monthly Capacity Incentive Amounts payable by Transco or by a User to the Billing Period in respect of which the other Invoice Items on the Invoice Document relate)."

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

<u>Gas and Electricity Markets Authority Response:</u>

> 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 **0488**, version **2.0** dated **23/08/2001**) 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 (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.