

Draft Modification Report
Capacity Forward & Option Entry Capacity Management
Modification Reference Number 0498

Version 1.0

This Draft Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

Transco anticipates that it will continue to have available the present daily capacity buy-back process described in section B2.9 of the Network Code. In addition it believes that it would be appropriate to develop alternative mechanisms, including forward and options contracts, for entry capacity management. Any new tools would be procured and operated under the auspices of the proposed Procurement Guidelines and System Management Principles Statement.

Initially two types of contract may be introduced, Forward and Option contracts. Forward contracts would consist of the buy back of an amount of capacity for a pre-defined period at an ASEP; shippers would indicate the volume offered per day and the price (in p/kWh/day). Option Contracts would provide Transco with a right to exercise and option to buy back up to an amount of capacity on any number of days up to a pre-determined maximum of days in a period at an ASEP as specified in such contract. There would be a two tier pricing structure with Transco publishing the exercise price (in p/kWh exercised) and shippers bidding a premium price (in p/kWh) and the volume offered. It is anticipated that Transco will define the precise details of the contracts on offer via an “invitation to tender”, that would, along with a set of terms and conditions and an accepted bid form the contract between an individual User and Transco. Each Forward contract would be exercised immediately following acceptance but for Option contracts, Transco would be able to choose when to exercise up until a final date and time (relative to the gas day) that would be stated in the invitation to tender. Transco would only be able to exercise each option contract up to the stated maximum number of times and an instance of partial exercise (where Transco confirms surrender of capacity for less than the maximum quantity available on any day under each contract) would count towards this total. Further details concerning the operation and use of capacity management tools are contained in the attached business rules as discussed at Worskstream meetings.

Transco believes that it would be potentially inefficient for the range of capacity management tools available to it to be enabled through differing contractual and governance routes. Transco therefore proposes that all entry capacity management tools should be procured and deployed under the auspices of the Procurement Guidelines and System Management Principles Statement respectively. If agreed, this would require the present Entry Capacity management processes to be removed from the Network Code.

It is further proposed that the Network Code should be amended to enable changes in Users holdings of Entry Capacity as a result of transacting with Transco for one or more of the aforementioned capacity management tools to be registered on the UK-Link System. Registration of such transactions is necessary to enable accurate calculation of overrun charges,

Section I liabilities and, depending on the final definition of the implementation of the System Operator incentive schemes, each Users share of costs and revenues arising from capacity neutrality arrangements as described in Modification Proposal 0520. Such costs and revenues may include net cash flows associated with incremental capacity sales and buy backs.

A further change is also proposed to enable fees (payments to shippers) for relinquishing capacity arising from an agreed entry capacity management transaction to be registered on capacity invoices. Credits would appear on invoices produced at the end of the month to which the contract applied, and where contracts span months would include a pro-rata proportion of the forward contract and option premium charges based on the relevant number of days. Option exercise charges would be included in the invoice for the month to which the exercise related.

It is intended that, if agreed, the revised processes should be in place for 1 April 2002.

2. Transco's Opinion

Ofgem has now published its final proposals for Transco System Operator Incentives to be effective from 1 April 2002. The proposals include a System Operator Buy-back Incentive. This is intended to incentivise economic and efficient buy back of entry capacity. In order to facilitate this, forward contracting for entry capacity buy back has been discussed. Transco agrees that it is desirable for it to have available a wider range of tools and additional flexibility to procure and improve the efficiency of the entry capacity management process.

Transco envisages that, in line with Ofgem Proposals for the System Operator Incentive Schemes and the associated licence modifications, Procurement Guidelines and System Management Principles Statement documents will be developed which will define the approach that Transco will use to procure and deploy such tools respectively. This proposal assumes that both documents will be developed and implemented for 1 April 2002 and that they will operate alongside the Network Code. It is anticipated that the System Management Principles Statement will contain guidelines for the deployment of capacity management tools including the existing buy back mechanism. The Procurement Guidelines will outline the tools that Transco expects to purchase and the mechanisms used. However some aspects of the existing buy back mechanism such as the process for posting offers, will remain within the Network Code.

This proposal would enable Transco to manage the entry capacity regime using a wider range of contractual tools designed to facilitate more efficient regime operation. Decisions between contracting forward or waiting to see if buying back capacity in the prompt market is necessary would in essence be subject to Transco's risk management assessment.

A choice of tools and of when to contract for those tools could enable Transco to achieve more efficient and economic entry capacity management. This will provide both Users and Transco with benefits if a more efficient outcome is gained in the context of the System Operator Buy-back Incentive.

The process of forward contracting could also provide Transco with market-based signals regarding when to schedule maintenance on the NTS.

If Transco later discovers that the capacity it had bought back was in fact available, then it would seek to resell the capacity to ensure that the maximum possible commercial capacity is available to Users.

In Transco's opinion it is appropriate that contracts for capacity buy back should be treated in the same way as buy back bids currently are with respect to overrun charges and Section I payments determination. For overrun charges determination, this would include consideration of the exercise price part of an options contract where that contract was exercised on the day and the price for forward contracts where the day on which the overrun occurred was within the contract period. For Section I charges, the exercise element of an option contract would be included where the option was available for exercise but not taken. This will provide the appropriate incentives on Users to purchase capacity and on Transco to either buy back or forward contract for capacity in the market place. It should be noted that until new systems are implemented in August 2002, option and forward contracts will be treated exactly the same as buy back offers for the purposes of these calculations. Further changes as proposed in Modification Proposal 0500 may be implemented at a later date. Users' views concerning the use of prices arising from forward contracting are sought as part of the consultation process for this Modification Proposal.

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

The proposal might afford Transco an opportunity to operate its pipeline system more efficiently and economically, as it will facilitate more efficient management of entry capacity. It may also allow Transco to operate more effectively under its Capacity Buy Back Incentive, the parameters of which have been set assuming such tools are available. The introduction of forward and option contracts and potentially other capacity management tools will enable Transco to make more efficient decisions. The structure of such contracts may also allow more Users to participate in the capacity management process, for example forward contracting may enable some Users that do not have very short term gas flexibility and are unable to compete in the within day market, to participate. Thus the proposed arrangements should be expected to further promote competition between Shippers.

4. The implications for Transco of implementing the Modification Proposal , including a) implications for the operation of the System:

The proposal may enable Transco to manage entry capacity in a more efficient and economic manner. It will have no direct effect on the day to day operation of the System, however it may allow Transco to schedule maintenance and development of its System at those times when capacity is less valued by shippers. Additionally, if the relativity of assessed prices available via forward contracting and prompt buy back are favorable Transco might be encouraged to keep the commercially available capacity at levels close to physical capability at some points and some times thus encouraging more acceptable flows onto the system than have been experienced since NGTA.

b) development and capital cost and operating cost implications:

No significant costs are anticipated.

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:

These developments are part of the wider RGTA developments and systems development costs are included within ongoing IT costs.

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

This proposal is consistent with assumptions made in setting the System Operator Incentives.

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

This proposal may reduce contractual risk for Transco, as it may reduce the forward exposure via the buy back incentive that Transco would otherwise face, however this should be set against Transco's ability to accurately predict the appropriate level of forward contracting.

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

Systems developments will be required to implement this proposal, it is anticipated that that these will be delivered at the beginning of August 2002. If Transco chooses to purchase capacity management tools before this then off-line mechanisms will be used to operate such contracts.

7. The implications of implementing the Modification Proposal for Users

This proposal may lead to a more efficient and economic entry capacity regime. The sharing factors in Transco's Capacity Buy Back Incentive mean that Users are aligned with Transco in seeking to reduce the costs of capacity management. The proposal will provide options for Transco in respect of capacity management, providing additional commercial opportunities for Users, increasing competition in the provision of services between Users and may lead to levels of capacity management costs. The Modification Proposal also provides Users with the opportunity to contract with Transco in advance of the gas day, although they would not be obliged to do so. This may provide additional commercial and operational benefits.

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

None are envisaged.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

In addition to the changes to the Network Code, a number of changes may be required to Transco's GT Licence to enable the implementation of entry capacity management contracts. There is a possibility that this Modification Proposal could impact on the Transco exemption under the FSMA. Transco anticipates that Ofgem and Transco will be exploring these issues with HM Treasury. Licence Condition 7 applies to contracts related to the Network Code, requiring their individual derogation by Ofgem. New Licence wording might provide a degree of certainty to avoid this complexity and could be included within either existing conditions or a new condition describing the Procurement Guidelines but they would be subject to the outcome of the HM Treasury discussions. It is anticipated that these issues will be dealt with in a consistent manner through the changes required to enable Transco's new price control arrangements.

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

Advantages:

- The Proposal would be expected to enable capacity management to be carried out in a more efficient and economic manner.
- The Modification Proposal is intended to enable alternative tools for capacity management, it does not imply any obligation on Users or Transco to use such tools
- The use of forward contracting for capacity management may further promote the development of a forward price curve for capacity and a more liquid secondary market

Disadvantages:

- Shippers may need to develop predictive models to assist them in valuing capacity management contracts
- The development of option and forward contracts for capacity management will add complexity to the Entry Capacity regime

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

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 comply with any 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 due to any changes to Transco's GT Licence as described above

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

There are no such works required.

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

Draft Modification Report circulated	7th February 2002
Representations close out	28th February 2002
Final Modification Report issued	7th March 2002
Ofgem decision expected	21st March 2002
Implementation	1st April 2002

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation.

17. Text

TRANSITION DOCUMENT, PART II

Insert new paragraph 8.1.2A to read as follows:

"8.1.2A B2 For the purposes of the calendar months April 2002 to September 2002 (inclusive):

- (1) Transco may, for the purposes of Capacity Management:
 - (a) initiate a capacity selection period in accordance with the System Management Principles;
 - (b) accept daily capacity offers on any Day in accordance with the System Management Principles at an Aggregate System Entry Point in such aggregate amounts as is consistent with the System Management Principles (and acceptance of daily capacity offers during each capacity selection period shall for the avoidance of doubt not be limited to quantities of Firm System Entry Capacity equal to any prevailing Firm Capacity Shortfall); and

- (c) Sections B2.9.8 to B2.9.13 (inclusive) shall not apply.
- (2) the:
 - (a) "**System Management Principles** " are the principles established by the Transco Licence pursuant to [Special Condition []] which Transco will follow when undertaking (inter alia) Capacity Management;
 - (b) "**Capacity Management**" means, in relation to an Aggregate System Entry Point and in relation to any Day:
 - (i) the entering into of agreements for the purposes of the management of a capacity constraint by Transco and a User; and/or
 - (ii) the curtailment of Interruptible System Entry Capacity in accordance with the System Management Principles and Section B2.10; and/or
 - (iii) the acceptance by Transco of daily capacity offers submitted by Users in accordance with the System Management Management Principles and Section B2.9, in each case for the purposes of the management of a capacity constraint;
 - (c) "**Capacity Management Charges**" are all amounts payable by Transco to a User pursuant to a Capacity Management Agreement; and
 - (d) "**Procurement Guidelines**" are the guidelines established by the Transco Licence pursuant to [Special Condition []] identifying the forms of agreement (each a "**Capacity Management Agreement** ") pursuant to which Transco may secure the surrender of Firm System Entry Capacity.
- (3) For the purposes of Capacity Management Transco may enter into a Capacity Management Agreement with a User.
- (4) Where pursuant to the terms of a Capacity Management Agreement a User surrenders Firm System Entry Capacity at an Aggregate System Entry Point in relation to a Day, the amount of the User's Available Firm System Entry Capacity held by the User at the Aggregate System Entry Point shall be reduced by the amount surrendered by the User pursuant to the terms of the Capacity Management Agreement.
- (6) For the purposes of:

- (i) Section B2.12.3(a), in determining the highest accepted offer price in respect of a Day, account shall also be taken of the exercise price (in pence/kWh/Day) paid by Transco pursuant to a Capacity Management Agreement in respect of the surrender of System Entry Capacity on such Day (provided however that no account will be taken of any amount paid by Transco pursuant to Capacity Management Agreement by way of a premium and which for any other purpose under the Code is determined as attributable to such Day);
- (ii) Section B2.13.3, Relevant Capacity Costs in respect of an Aggregate System Entry Point in relation to a calendar shall include the aggregate amount of Capacity Management Charges payable by Transco and attributable to a Day in such month (for which purposes any premium payable by Transco shall be attributable to a Day pro rata to the number of Days during which Transco may exercise rights in respect of the surrender of Firm System Entry Capacity pursuant to the relevant Capacity Management Agreement); and
- (iii) Section I3.7.2, for the purposes of determining the aggregate notional surrender costs on a Day in respect of an Aggregate System Entry Point, account shall also be taken of the exercise price (in pence/kWh/Day) payable by Transco pursuant to a Capacity Management Agreement were Transco to exercise its rights thereunder) in respect of the surrender of System Entry Capacity on such Day (provided however that no account will be taken of any amount payable by Transco pursuant to the Capacity Management Agreement by way of a premium and which for any other purpose under the Code is determined as attributable to such Day)."

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: