

URGENT Modification Report
Removal of Monthly Capacity Incentive Limit Amounts
Modification Reference Number 0452
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 Of gem has agreed that this Modification Proposal should be treated as Urgent because changes to Transco's capacity incentive may impact on the bidding strategies in the Monthly System Entry Capacity auction, which is presently scheduled to commence on 30 January 2001. Of gem believes that the Modification Proposal should be granted urgent status in order to ensure that the parameters of the capacity incentive regime are clarified prior to the commencement of the auctions.

Procedures Followed:

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

Issued to Ofgem for decision on urgency	16 January 2001
Proposal agreed as urgent	18 January 2001
Proposal issued for consultation	19 January 2001
Close out for Representations	24 January 2001
Final report to Ofgem	25 January 2001
Ofgem decision expected	28 January 2001

1. The Modification Proposal

To strengthen commercial incentives by removal of the monthly cap and collar from Transco's capacity incentive mechanism.

2. Transco's Opinion

Transco is of the opinion that it is inappropriate to re-open discussion about the appropriateness of individual capacity incentive parameters mid-way through the period to which a capacity incentive applies. Any changes to the capacity incentive should take into account the totality of factors to ensure that any revision should improve upon delivery of the objectives set for the capacity incentive. Piecemeal change will carry a risk that some of the benefits of the capacity incentive could be unintentionally diluted. Changes to that incentive, mid-way through an incentive period could also have the effect of detracting from the desired incentive properties by creating further uncertainty with regard to its operation into the future.

The appropriateness of monthly caps and collars was discussed during the initial development of the capacity incentive. At that time it was known that the cap or collar could be reached in any month but it was considered an appropriate tool to maintain a continuing application of incentives throughout a 12-month period. In any case it should be noted that an incentive to mitigate buy-back costs by increasing daily capacity is always present regardless of where a monthly (or annual) collar is set.

Transco is also concerned that no discussion has been entered into between Transco and Users regarding the appropriate treatment of cash flows arising from this proposal. It is anticipated by Transco that an annual settlement of the capacity incentive would be required if this proposal is to be implemented. Transco believe that it would be appropriate to discuss further the consequences of removing the monthly cap and collar before implementation of the proposal.

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

The proposer has not indicated how the proposal would better facilitate the relevant objectives.

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

a) implications for the operation of the System:

No implications are anticipated.

b) development and capital cost and operating cost implications:

No such implications 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:

Not applicable.

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

Not applicable.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

The proposal, if implemented, would increase the level of risk for Transco by increasing its exposure to buy-back costs. Transco is of the opinion that the increased risk is not mitigated by a matching potential for increased daily capacity sales. The introduction of Monthly Interruptible System Entry Capacity (MISEC) has had the effect of reducing the potential for capacity incentive income from sales of daily capacity.

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

No implications are anticipated.

7. The implications of implementing the Modification Proposal for Users

The implications for Users are unclear. The proposal has not specified a preferred treatment for costs or revenues accrued to the capacity incentive. It is anticipated that the present monthly settlement would probably be changed to an annual settlement with a consequent effect upon cash flow between Transco and Users.

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

No implications are anticipated.

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 anticipated.

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

Advantages:

Commercial incentives upon Transco are strengthened up to a level consistent with the annual capacity incentive limit.

Disadvantages:

Piecemeal change could have unforeseen consequences for operation of the capacity incentive.

Changes mid-way through an incentive period could detract from certainty regarding operation of incentives.

Cash flow treatment for the capacity incentive remains unclear.

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

Seven representations have been received. The five representations in support of the proposal include:

Aquila
Alliance Gas
TXU Europe Energy Trading
Yorkshire Energy
British Gas Trading

Two representations opposing the proposal have been received from:

Scottish and Southern Energy
Northern Electric

Aquila argued that the proposal would provide a more consistent incentive structure for Transco and thereby help to minimise neutrality costs.

TXU and Yorkshire Energy agree that the proposal could help to improve Transco's commercial incentive to maximise revenue and minimise costs.

The proposer, BGT, reiterated that the monthly capacity incentive limit should be removed in order that Transco's direct financial incentives are maintained at all times and are not subject to an artificial cap and collar. This, BGT suggested, would align the Transco incentive with those of shippers in seeking to minimise costs and maximise revenues.

BGT and Scottish and Southern Energy also highlight that removal of, or an increase to, the annual cap and collar may become an issue that also requires attention but is difficult to address in the absence of Monthly System Entry Capacity (MSEC) quantities to be released at each terminal and whilst there is uncertainty over the length of the auction period.

Northern Electric and Scottish and Southern Energy believe that there is a continuing justification for a monthly cap and collar to ensure that Transco is unable to prematurely reach its annual target, an event that could have a knock on effect of reducing subsequent incentives to maximise capacity availability and to take price efficient buy-back actions.

Northern Electric also highlights that the industry holds an assumption that capacity incentives should be symmetric and therefore there is some justification in reviewing Transco's past performance against the capacity incentive prior to introducing changes. Scottish and Southern Energy supports the view that a comprehensive review of the capacity incentive would be appropriate prior to further developments.

Northern Electric does not believe that it is appropriate to introduce a piecemeal amendment to the capacity incentive. Northern Electric also suggests that it would appear sensible for the community to wait for Of gem's review of the recent operation of the capacity regime, particularly with respect to recent buy-backs, before the industry is in a position to fully consider interactions between capacity quantities released in the auctions and Transco's capacity incentive.

Scottish and Southern Energy considers it an impossible task to comment meaningfully on proposals to modify the capacity incentive until after the outcome of modification proposals 0444 and 0445 are known.

Scottish and Southern Energy also observed that it remains unclear if the incentive amount should be adjusted to £2.5m for the remainder of the year from April through to September or alternatively if it is intended that the capacity incentive should be accounted over 12-months commencing on 1 April.

Scottish and Southern Energy put forward a suggestion that consideration should be given to an alternative mechanism whereby the annual cap is divided between months or days in a more effective way.

Scottish and Southern is also uncertain what happens with regard to the cash flows arising out of the change to the monthly cap and collar. It also questioned what would happen if Transco reached its collar early in an incentive period. Would all further costs be picked up by Users? Or, would the overall position be unknown until the end of the capacity period? It concludes that this aspect of the proposal must be ascertained so that all participants are fully aware of the implications of the change.

Transco's response

Transco accept that incentives may be diluted if a monthly cap or collar is reached. However, it continues to believe that an incentive will remain to mitigate buy-back costs by increasing daily capacity sales. Transco believes that the monthly cap and collar has merit in performing its original function to ensure that incentives will be in place every month of the capacity incentive period. If that limit is reached in one month, then the incentive will be renewed at the start of the next month. This proposal, as highlighted by a number of respondents, would not address the consequences of reaching an annual cap or collar early in an incentive period. Transco remains of the view that all aspects of the capacity incentive, including its goals, should be reviewed at one time to ensure the best possible outcome from any further development.

Transco also agrees with concerns to understand the outcome of Of gem's capacity review prior to initiating further changes to the incentive. That review could be particularly relevant because it concerns activity regarding buy-back of entry capacity.

Transco is unclear how cash flow arising from operation of the capacity incentive should be treated. Neither the proposer nor any respondents have divulged any views on how this issue should be addressed. It is possible for Transco to introduce an annual accounting settlement period, though it is probably more appropriate that further discussion is allowed for this issue.

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

Not applicable.

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

Not applicable.

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

No programme of works is required.

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

No timetable is offered.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommend that this proposal is not implemented.

17. Restrictive Trade Practices Act

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

18. Transco's Proposal

This modification Report contains Transco's proposal not to modify the Network Code and Transco now seeks agreement from the Director General in accordance with this report.

19. Text

As Transco is not in support of this proposal no legal text has been provided.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Gas and Electricity Markets Authority Response:

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0452**, version **1.0** dated **25/01/2001**) 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 (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.