

Modification Report
Suspension of the Neutrality and Compensation Value Audit
Modification Reference Number 0467

Version 1.0

This 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

Section V of the Network Code requires a Neutrality and Compensation Value Audit (NCVA) to be undertaken for each Gas Year or 'relevant period'. This is overseen by a sub-committee of the Network Code Committee. Following the completion of three satisfactory audits, covering the period March 1996 to March 1999, the NCVA sub-committee noted that any future audits would require a competitive tender prior to the award of a new contract. However, to cover the period March 1999 to September 1999 an extension to the contract was agreed with the then current auditor, on the understanding that this would close the review period at the end of the gas year. Subsequently a single source tender was awarded to the same auditor, for a further three months. This was to provide assurance about the operation of the processes following changes in the regime caused by the introduction of the New Gas Trading Arrangements (NGTA) and Modification Proposal 0204 - Amendment to Standards of Service.

In July 2000, following publication of the latest audit, the NCVA sub-committee considered it an appropriate opportunity to review the current status of the audit. In particular the sub-committee considered the cost of the audit to users, approximately £200,000, against the benefits and material value of the issues identified.

The NCVA Sub-Committee concluded that it considered it appropriate at this point to recommend the suspension of future audits. This recommendation was based on the proviso that measures were in place that may afford shipper confidence in Transco's compliance with audit provisions in the Network Code, for both neutrality and compensation areas. It was agreed that Transco should present an overview of its audit processes, and this was presented to the Network Code Committee. Following the presentation, the Committee agreed that there was little interest in pursuing a tender for a third party auditor and accepted that a Modification Proposal, to suspend the NCVA, should be raised.

2. Transco's Opinion

Transco is broadly neutral to this Modification Proposal, and therefore believes it is primarily a matter for Users to recommend whether or not it is appropriate to implement. However, based on views expressed by Users at the Network Code Committee, Transco

presently supports implementation of this Modification Proposal and suspension of the Neutrality and Compensation Value Audits.

Following the last NCVA, analysis revealed that the cost of the audit exceeded the total value of the issues identified. It could be argued that the cost of the audit is immaterial - it is confidence that neutrality and compensation processes operate in accordance with provisions in the Network Code that is the key purpose of the audit. However, Transco has provided examples to the Network Code Committee of the internal procedures and controls it has in place to ensure compliance. Transco is of the opinion that these continuing controls can be regarded as offering Users reassurance that the processes are operating as intended. In this context, the majority of errors identified as a consequence of the latest NCVA had been previously recognised through the Transco internal audit processes and controls and were being addressed.

The Network Code Committee has expressed the view that it is reasonably confident that Transco internal controls and processes are sufficiently thorough that suspending the NCVA merits consideration. Information in respect of controls and processes for compensation, incentives and neutrality is currently available to shippers via standards of service reports on SIS and via the Liabilities Sub-Committee reports.

In the light of the cost to Users of the NCVA, both in terms of the contract price and the commitment of time to the process, and the lack of material issues identified in audits to date, Transco believes there would be merit in suspending the audit requirement. The requirement could, however, be reinstated should User concerns emerge in future.

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

The Modification Proposal better meets the relevant objectives in that it would afford more economic operation. This would be achieved by reducing neutrality costs, since the cost of the Audit is recovered via the neutrality mechanism.

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

Transco is not aware of any such implications.

b) development and capital cost and operating cost implications:

Transco is not aware of any such implications.

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 require no such recovery of costs.

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

Transco is unaware of any such consequences.

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

Transco is unaware of any such consequence.

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

Transco is unaware of any such implications.

7. The implications of implementing the Modification Proposal for Users

Transco is unaware of any such implications.

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

Transco is unaware of any such implications.

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

Transco is unaware of any such consequence.

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

Advantages:-

Reduced cost for Users

Disadvantages :-

No third party audit assurance that relevant processes are performed in accordance with Network Code processes.

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 4 respondents.

2 respondents express support for the proposal, Powergen and British Gas Trading.

1 respondent, ExxonMobil, expresses the view that it has no objections to the proposal.

1 respondent, Innogy, is not in support of the proposal.

Limitations of Current Neutrality and Value Compensation Audit (NCVA)

British Gas Trading and ExxonMobil note that from the initiation of the NCVA it was decided that a full audit would be prohibitively costly. It was therefore agreed that the community would have to rely upon a standard accounting audit process for assurance that Transco adhere to specified practises. ExxonMobil considers that the current NCVA is providing little value to shippers and arguments against suspension are therefore weak. British Gas Trading concurs that the NCVA adds no value to the process and believes that the lack of support for the NCVA sub-committee demonstrates a commonly felt view.

Establishment of New Energy Regimes

Innogy expresses concerns that any new regime will require changes to Transco invoicing systems and processes. Therefore shippers will require adequate assurance over Transco's compliance with the provision of the new regime. It is of the view that the NCVA will provide assurance that new processes are operating correctly. Innogy adds that it would prefer to consider the suspension of audit once the energy balancing regime has been established.

Proposed Alternative Audit Arrangements

ExxonMobil suggest that Transco should establish a workgroup to examine areas of operation where shippers are most exposed and where self verification of the rules is not possible or possible at a high cost. It observes that the individual shipper is unable to verify specific liabilities as the view must be assessed in aggregate over the entire community. ExxonMobil suggest that the workgroup should look at both areas of operation that are audited by Transco and Ofgem and areas that currently are not. It advises that the cost of auditing key aspects of Code operation would need to be examined and in addition the basis of sharing costs and billing would need to be reviewed. ExxonMobil propose that Transco should establish such a workgroup via a suitable Modification Proposal with a completion date of April 2002, when a number of changes to standards of performance, neutrality and Transco incentives are likely to commence in line with the price control.

Re-instatement of the Audit

Powergen express the view that it is reassured by Transco that its internal controls for compliance are sufficient for the foreseeable future. It is further comforted by the understanding that the suspension can be ongoing until such time as shippers might feel the need to re-instate it. Innogy raises concerns that should the NCVA be suspended it would be hard to re-instate the audit without unanimous consent from all shippers due to audit cost being recovered across all shippers.

Transco Response

Establishment of New Energy Regime

Transco notes that three of the respondents express the view that it is appropriate to consider the immediate suspension of the NCVA. However it acknowledges that Innogy would wish to consider the issue of suspension after proposed amendments to the energy regime are 'established'. In respect of Innogys view Transco comments that because the energy regime is constantly evolving it may be difficult to assess when the energy regime is considered to be 'established', and consequently at which point the suspension of the NCVA would be appropriate. Transco suggest that it may be appropriate to suspend the audit until such time as there is significant change that merits re-instatement of the audit. Transco observes that if the proposal is accepted and the NCVA is suspended, its reinstatement can be initiated via consent from the Network Code Committee. The proposed provisions are included as part of the Modification Proposal.

Reinstatement of the NCVA

In respect of Innogys concerns over the NCVA reinstatement process, Transco clarifies that reinstatement would not require unanimous shipper consent. As previously iterated reinstatement provisions are included in the Modification Proposal. It is recognised that this may offer assurance that at any time the NCVA can be resurrected should the Network Code Committee deem it to be appropriate. Additionally the Network Code Committee has agreed that should the Proposal be implemented reinstatement of the audit would be reassessed on an at least yearly basis.

Alternative Audit Arrangements

In respect of ExxonMobils comments which suggest establishing a workgroup to discuss future audit developments. Transco is of the view that it may be appropriate to raise this proposal for discussion at a future Network Code Committee Meeting.

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

Transco is unaware of any such requirement.

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

Transco is unaware of any such requirement

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

No programme of works would be required.

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

If approved, the proposal could be implemented without delay as no system changes or other works are required.

16. Recommendation concerning the implementation of the Modification Proposal

Based on views of the Users expressed in the Network Code Committee Transco recommends the implementation of this Modification Proposal.

17. Restrictive Trade Practices Act

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

18. Transco's Proposal

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

Section V:

Paragraph 12.1.1

Amend to read:-

12.1.1 Transco will, subject to paragraphs 12.1.3 and 12.1.4, appoint

Paragraph 12.1.3

Add the following new paragraph:-

12.1.3 A Neutrality Auditor may not be appointed for a relevant period:-

(a) where Transco proposes after consultation with the Network Code Committee or any relevant Sub-committee and where the Director (upon Transco's application) gives Condition 7(4) Approval that such Neutrality Auditor not be appointed; or

(b) where:-

(i) pursuant to this paragraph 12.1.3 a Neutrality Auditor was not appointed for the immediately prior relevant period; and

- (ii) Transco reasonably determines that such Neutrality Auditor should not be appointed after consultation with the Network Code Committee or any relevant Sub-committee, unless (upon the application of Transco or any User made within 10 Business Days after Transco notified to Users the decision of the Committee or Sub-committee) the Director in any case shall give Condition 7(4) Disapproval.

Paragraph 12.1.4

Add the following new paragraph:-

12.1.4. In the event that a Neutrality Auditor is appointed for a relevant period following relevant period(s) where (pursuant to paragraph 12.1.3) the Neutrality Auditor was not appointed, he may not review any prior relevant period unless expressly instructed by the Network Code Committee in accordance with paragraph 12.2.1.

Paragraph 13.8.1

Amend to read:-

13.8.1 Transco will, subject to paragraphs 13.8.3 and 13.8.4, appoint

Paragraph 13.8.3

Add the following new paragraph:-

13.8.3 A Compensation Value Auditor may not be appointed for a relevant period:-

- (a) where Transco proposes after consultation with the Network Code Committee or any relevant Sub-committee and where the Director (upon Transco's application) gives Condition 7(4) Approval that such Compensation Value Auditor not be appointed; or
- (c) where:-
 - (i) pursuant to this paragraph 13.8.3 a Compensation Value Auditor was not appointed for the immediately prior relevant period; and
 - (ii) Transco reasonably determines that such Compensation Value Auditor should not be appointed after consultation with the Network Code Committee or any relevant Sub-committee, unless (upon the application of Transco or any User made within 10 Business Days after Transco notified to Users the decision of the Committee or Sub-committee) the Director in any case shall give Condition 7(4) Disapproval.

Paragraph 13.8.4

Add the following new paragraph:-

13.8.4. In the event that a Compensation Value Auditor is appointed for a relevant period following relevant period(s) where (pursuant to paragraph 12.1.3) the Compensation Value Auditor was not appointed, he may not review any prior relevant period unless expressly instructed by the Network Code Committee in accordance with paragraph 13.9.1.

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 **0467**, version **1.0** dated **01/08/2001**) 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 appropriateprovided 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.