

**Modification Report**  
**Restoration of Funding for National Top-up**  
**Modification Reference Number 0472**

Version 3.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

**1. The Modification Proposal**

The Modification Proposal was as follows:

"Network Code provisions require Transco, as Top-up Manager, to book and fill storage capacity in order to meet the 1-in-20 peak day and 1-in-50 severe year security criteria for national supply/demand. Transco proposes that the net costs of this should be recovered from Users through the Top-up neutrality mechanism.

Part of the national requirement may already have been provided through Constrained Top-up. The present proposal only applies to the costs of the remaining national Top-up requirement."

The Justification within the Modification Proposal was as follows:

"When the Network Code was first developed, it was generally agreed that it was desirable for gas to be available in storage in order to help provide security of supply. Where bookings were not adequate to deliver this, additional bookings should be made (top-up). The outcome incorporated in Section P of the Network Code involved Transco acting as Top-up Manager. Arrangements were also included such that any net costs would be passed through to Users in accordance with a Top-up neutrality mechanism.

Transco's Safety Case includes Top-up as part of the safety regime, and refers to Standard Condition 31(9) of the Gas Supplier Licence. That condition requires a Supplier to either meet domestic supply security standards in relation to their domestic customers, or secure that gas conveyed by public gas transporters for supply to domestic customers is conveyed in conformity with those transporters' network codes. Standard Condition 31(10) of the Supplier Licence defines domestic supply security standards i.e. supplies must be sufficient to meet 1-in-20 peak day and 1-in-50 severe year demands. Standard Condition 7 (1) (d) of the Public Gas Transporter Licence requires the transporter to establish a network code calculated (inter alia) to provide "reasonable economic incentives for relevant suppliers to secure that the domestic supply security standards (within the meaning of condition 31(10) of the Standard Conditions of Gas Supplier Licences) are satisfied as respects the availability of gas to their domestic customers", and Top-up is part of the arrangements through which Transco meets this condition.

The Network Code obliges Transco as Top-up Manager to book and fill available storage on a national basis, as necessary to meet the 1-in-20 peak day and 1-in-50 severe year security of supply criteria. Ofgem has previously argued that Top-up is not necessary, and Transco should be pro-active in seeking to remove its Top-up related obligations. Consistent with this view, Transco was directed to implement Modification

Proposal 0297, which removed the Top-up cost recovery mechanism from the Network Code.

In light of Ofgem's position, Transco has sought to remove or reduce the Top-up obligations in the Network Code and its Safety Case. However, the HSE has made it clear that it will not accept any amendment to the Safety Case which involves such a reduction, as this could reduce system security levels.

Given the continuing existence of the Safety Case reference and the Network Code obligation to book and fill storage, assuming Users have not done so to the level expected to be sufficient to maintain supplies on a 1-in-20 peak day or in a 1-in-50 severe year, Transco believes it is appropriate that the funding arrangements should be reinstated. This Modification therefore proposes reinstatement of the previous Top-up neutrality mechanism that was originally included in Section P of the Network Code.

While Transco proposes returning to the previous mechanism for allocating any Top-up costs between Users, it recognises that some concerns have been raised in the past about the continuing appropriateness of this method of cost recovery. Transco would welcome alternative proposals for how these costs should be shared between Users."

## **2. Transco's Opinion**

Transco believes that the costs of unavoidable obligations, such as Top-up, should be reflected in the level of income it is permitted to collect from Users and therefore this proposal should be implemented.

When the Network Code was originally written, it was agreed in discussion on security of supply that Top-up storage might be required, and should be funded by Users through the Top-up Neutrality mechanism. After discussions on the most appropriate body to administer Top-up arrangements Transco agreed to take on this role provided it was funded by Users.

Implementation of Modification Proposal 0297 removed this funding. Ofgas stated in its implementation letter that Transco should bring forward proposals which it expected at the time would remove/reduce Top-up requirements.

The HSE has not agreed to the removal of Transco's Top-up obligations from its Safety Case. However, at a meeting of Ofgem, HSE and Transco in November 2000, the HSE agreed to consider whether Top-up requirements could be reduced to safeguard domestic demand rather than all firm demand. Accordingly, Transco proposed an amendment to its Safety Case and put forward Network Code Modification Proposal 0449. However, after obtaining legal advice, the HSE concluded that such a change would be inconsistent with the 1996 Gas Safety (Management) Regulations. Transco therefore withdrew its Modification Proposal.

Since Transco's proposals to remove or reduce Top-up requirements have not been accepted - contrary to Ofgas' expectation when implementation of Modification Proposal 0297 was directed - the funding of Top-up should now be restored.

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

The provision of Top-up should be consistent with "the provision of reasonable economic incentives for relevant suppliers to secure that the domestic supply security standards ... are satisfied as respects the availability of gas to their domestic customers". One of the reasonable economic incentives is provided by accepted Top-up offers on the OCM setting appropriate System Marginal Buy Prices in severe weather conditions. However, this incentive would be reinforced by Users having to fund Top-up if their own storage bookings did not in total meet the security criteria determined under the "storage monitor" arrangements. Whilst this incentive would not be entirely focussed it would still provide a general incentive on all applicable Users.

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

Implementation of this Modification Proposal would increase the incentive on Users to book storage. This would lead to reduced usage by Transco of Top-up for daily system balancing during severe weather conditions.

**b) development and capital cost and operating cost implications:**

Transco does not anticipate significant development or operating cost implications as a result of the implementation of this Modification Proposal.

**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:**

Any costs associated with implementation would be treated as normal business costs with no additional cost recovery proposed.

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

Transco is not aware of any 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**

The level of contractual risk would be expected to reduce, as Transco would no longer meet the cost of funding Top-up.

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

Transco is unaware of any implications for computer systems, as the Modification Proposal would reintroduce previous invoicing processes.

**7. The implications of implementing the Modification Proposal for Users**

Costs for the 2001/02 Storage Year would be recovered with reference to Users' UDQOs at firm supply points for the months December 2001 to March 2002 inclusive, and similarly in subsequent Storage Years.

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

Users may seek to pass Top-up costs on to Suppliers and Consumers.

**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**

Funding of Transco's obligations in its role of Top-up Manager would be reinstated.

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

Advantages

- Consistency between regulatory obligations and funding.
- Users might book storage capacity more in line with their supply obligations if they knew that a neutrality mechanism would apply to them in the event that insufficient booking took place.

Disadvantages

- Top-up costs would not be focussed on those Users causing them by under-providing peak gas for their demands, however as noted in the Justification to this Modification Proposal, Transco is open to alternative proposals.
- Changes to the storage regime would be made within the 2001/02 Storage Years after Users had made storage booking decisions based upon the current storage regime. This is not, however, unprecedented.

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

Representations have been received from the following Users:

BP Gas Marketing Limited (BP)  
British Gas Trading (BGT)  
Powergen UK plc (Powergen)  
Scottish and Southern Energy plc (SSE)  
Shell Gas Direct Limited (Shell)

BP confirmed in its representation that it had no objection to this Modification Proposal. BGT, Powergen, SSE and Shell did not support implementation of this Modification Proposal.

Representations centred on the following topics:

### **Justification for Change**

BGT pointed out that there were "no material changes to the Code or to Transco's Safety Case since the existing rules relating to 'national' Top-Up cost treatment were implemented by Modification 297. Moreover this Modification recognises this. There are therefore no changes advanced to justify an alteration to the existing rules." It further maintained that "it is not, in our view, the case that Ofgem's approval of Modification 297 was contingent upon Transco succeeding with any proposals to 'remove or reduce Top-Up requirements'." SSE commented that "we do not see what has changed in the two years since Ofgem concluded that Top-Up was no longer required, on the basis that peak gas supply sources would be more available and diverse, and hence that shippers should not be asked to fund it."

### **Transco's Response**

Whilst there may have been no material change to Transco's safety case since the implementation of Modification Proposal 0297, the implementation letter from Ofgas was written in the expectation "that top up will be removed from the network code". Transco concluded from this statement that the removal of Top-up was a relevant assumption underlying the implementation decision. Transco discussed the potential removal of Top-up with HSE, which obtained legal advice on one of the key assumptions that would have facilitated the removal of Top-up. Having obtained this advice, HSE informed Transco that this key assumption was not consistent with the legal interpretation of the Gas Safety (Management) Regulations 1996. Transco has concluded from this that a change in one of the key assumptions that underlay Ofgas' decision on Modification Proposal 0297 was sufficient to justify submission of this Modification Proposal

### **Restoration of a Neutrality Mechanism**

In BGT's view, implementation would "reinstatethe 'unfocused' smear of any 'national' Top-Up costs between shippers which was removed by Modification 297. This would be unfair and inequitable." It also stated that "A secondary discriminatory aspect is that the smears based on UDQOs would create a surcharge on interruptible users who probably would not contribute to the transmission support needs which the 2001/2 Constrained Top-Up is required to address, namely 'days 1-4' on Transco's 1-in-50 load duration curve. Shell maintain that the neutrality should be based upon Users' domestic demands and suggest that "Transco should investigate approaches to the funding of Top-up which smears the costs based on the number of domestic customers in shippers' portfolios." Powergen also raised concerns that the "top-up neutrality mechanism in this proposal is essentially an additional charge to all users to cater for the fact that some shippers have insufficient storage." SSE expressed concerns "about the proposal to return to the old smearing mechanism, whereby costs are recovered on the basis of a shipper's share of demand. For the prudent players that have taken steps to ensure that they meet their domestic security standards this would represent a cross-subsidy between shippers."

## **Transco's Response**

Transco believes that implementation of funding via a neutrality mechanism would better facilitate the achievement of its relevant objectives. At present the incentive to secure that the domestic supply security standards are satisfied is based on the high balancing charges that Users potentially face in severe weather. Implementation of this Modification Proposal would, however, re-introduce an additional incentive to book sufficient storage to meet security standards as any short-fall in such storage bookings would have to be funded by Users. Users would subsequently have the option of developing alternative approaches that they believe might better target costs, and could raise a Modification Proposal were such an approach identified. Implementation of the Modification Proposal would, however, restrict the basis of neutrality funding to Users' firm Supply Point portfolios so the question of "interruptible Users" funding Users with only firm Supply Points would not arise. Prior to the HSE discussions on the continuing necessity of Top-up, Transco would have considered it appropriate for neutrality charges to be based upon Users' domestic Supply Point portfolios. However, such a basis would not be consistent with HSE's legal advice. This indicated that equivalent security of supply should be provided in respect of both domestic and non-domestic firm Supply Points.

## **Promotion of Alternative Bases for Funding**

BGT maintained that "Lattice have done nothing to promote discussion of alternatives to their proposal of an unfocused smear, such as might have led to a fairer basis for the treatment of "national" Top-Up costs. The first such discussion took place at the November meeting of the Planning & Security Workstream, at the instigation of shippers. Such discussions might have advanced a "cost-sharing" proposal whereby Lattice and shippers would bear reasonable proportions of any costs and the shipper elements were apportioned more fairly than by an unfocused smear. Transco have failed to develop this despite numerous promptings in shippers' responses to various Modifications and Consultation Documents relating to Top-Up and LNG." SSE expressed disappointment "that the draft modification report provides no detail about the alternative means of recovering Top-Up costs that were presumably discussed in the workstream meetings."

## **Transco's Response**

The issue of how charges might be levied on Users in a manner that incentivised booking of storage has been discussed at various times with interested parties including meetings of the PSS Workstream. As outlined in the Justification for this Modification Proposal, Transco would welcome alternative proposals being suggested as part of representations in response to this Modification Proposal. It remains open to Users to propose any alternative approach which they believe merits consideration. Recent discussion at PSS Workstream meetings has, however, led participants to recall previous discussions that concluded that funding on the basis of bookings of storage, beach supplies and allowances for interruption could have its own drawbacks. These are related to the fact that capacity and gas is not always obtained on primary markets but also through trades on secondary markets. To work effectively the community would require procedures that checked User's claims of gas and capacity purchased on the primary markets and

through trades.

### **Mid-Year Implementation**

BGT suggested that some shippers might “have made non-LNG provision for peak-shaving for 2001/2 which with their share of Top-Up costs (if this Modification were implemented) means they should have adopted a different strategy. The change proposed by Transco would impose charges on shippers which could have been reduced or avoided, for example if some or all shippers had made greater use of LNG bookings in making provision for their requirements for the 2001/2 winter and had procured less winter NBP (but not beach) gas. Key elements of these provisions, including storage bookings, cannot now be cancelled.” SSE pointed out that “Shippers/suppliers have taken a position with regard to their security of supply licence obligations, including the purchase of storage and other services. To introduce such a change midway through the storage year alters the economics on which those decisions have been based.”

BGT recalled Transco’s response to Modification Proposal 0297 in questioning “whether it would be appropriate to make changes in respect of [1998/9] Top-Up cost recovery ‘retrospectively’, as the Storage and Top-Up year had already begun.”

### **Transco’s Response**

In view of the relevant charges applying to different types of storage, Transco has difficulty in following the argument that Users would have booked more Short Duration storage space but less “NBP gas”, such as storage gas in Medium and/or Long Duration facilities, had a Top-up neutrality mechanism been in place. It does, however, acknowledge the possibility that, in aggregate, more storage space and/or deliverability might have been booked given the booking incentive that a Top-up neutrality charge would have provided. Transco views this as an advantage rather than a disadvantage of implementation.

Transco did argue against mid-year implementation of Modification Proposal 0297 and Users could have put forward similar arguments against implementation at that stage. Nevertheless, Transco acknowledges that this set a precedent which it feels can be followed by implementing this Modification Proposal.

### **Information Available prior to LNG Auctions**

BGT identify in detail the relevant quantities that demonstrate the supply/demand deficit and conclude, “this could and should have been done after last year’s 10-Year Statement was published and before the LNG auctions.” BGT further conclude “it is unreasonable for Lattice to have allowed potential LNG customers to have competed in those auctions (and made any other arrangements for 2001/2 around that time) and only later to advance a Modification which would alter the underlying costs and economics.”

### **Transco’s Response**

Whilst Transco is working with the industry to improve the accuracy of demand and supply predictions that it includes in its 10 Year Statement, it is inevitable that estimates are revised as more information becomes available over time. It is not always possible to plan the updating of estimates and operational events, such as LNG Auctions, in an ideal sequence and previous estimates have to be used.

### **Subsidy and Perverse Incentive**

BGT stated that a “disadvantage of the ‘unfocused smear’ and the use of unbooked Transco LNG capacity for Top-up is that this creates a subsidy in favour of that storage provider.” In the case of LNG the storage provider is part of the Lattice Group. Following from this, BGT pointed out if “this Modification were accepted Lattice plc would have a clear incentive to overstate national gas requirements where these could be addressed by LNG services, as Transco would be indifferent to such costs and Transco LNG Storage would gain because shippers would pay for additional use of under-utilised LNG sites.” BGT, however, made it clear that it was not suggesting that Lattice has acted improperly.

### **Transco’s Response**

Transco appreciates BGT’s acknowledgement of its propriety. Transco believes the issues raised by BGT are wider than Top-Up since they involve the general financial and regulatory arrangements facing LNG . This is expected to be addressed through Ofgem’s proposals for System Operative Incentives.

### **Alternatives to Top-Up**

Dynegy outlined the potential sources by which system flexibility might be provided and stated “the requirement on shippers to balance by the end of the gas day will ensure that capacity for all sources of flexibility will be in demand by shippers. The operators of storage facilities will find their products valued by the market, with all capacity offered for sale.” It believed also that “National Top Up may even distort signals for new investment in system flexibility i.e. a second Continental European gas interconnector.”

### **Transco’s Response**

Transco endorses the principle that markets should provide system flexibility. However, markets may not always provide the “insurance” required for exceptional conditions such as a 1 in 50 Winter. Transco believes that market mechanisms may be sufficient to provide supply security for domestic customers and that this is consistent with the underlying principles in Suppliers’ licences. Transco therefore commenced discussions with HSE and Ofgem in order to explore the removal of National Top-up from the Network Code and the implications this would have on Transco's Safety Case. From these discussions, Transco concluded that it would not be successful in agreeing a Safety Case unless the Top-up mechanism was available. However it did conclude, at that stage, that retaining Top-up for providing supply security for domestic customers would be viewed sympathetically by HSE. This lay behind Modification Proposal 0449. The HSE however, after considering this revised approach, has advised Transco that making a distinction between domestic load and other firm load in the system security planning process is not consistent with Gas Safety (Management) Regulations 1996 and this led to the identification of much higher quantities

of beach and/or storage gas. Based upon the previous discussions with HSE, outlined above, Transco does not believe that it would

be able at present to agree a Safety Case change with HSE based on market mechanisms alone, although it does not totally discount the idea were other developments, such as additional interconnectors, to become operational. This, however, may rely upon equivalent progress with gas liberalisation in Continental Europe.

Transco does not believe that Top-up exerts a brake on development of additional sources of flexibility. Indeed its charging structure is set such that these sources should become more attractive to Users than a Top-up neutrality charge, providing they fulfil their security of supply obligations.

### **Suppliers' Licence Obligations**

In a number of the representations already summarised, individual respondents implicitly recognised the licence obligations of Suppliers in providing sufficient supplies of gas to meet 1 in 50 winter conditions – at least as far as domestic customers are concerned. Transco supports this principle and would reiterate its intention to work with Users and regulatory agencies to ensure that its Network Code continues to reflect these underlying obligations. This would include any improvements as measured against the Relevant Objectives.

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

The funding of National Top-up is consistent with facilitation of Transco's compliance with its Safety Case.

#### **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**

Transco is unaware of any such requirement.

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

Transco is unaware of any such works.

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

Transco recommends that this Modification Proposal be implemented immediately.

#### **16. Recommendation concerning the implementation of the Modification Proposal**

Transco recommends implementation of this 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 P: TOP-UP STORAGE

*Amend paragraph 6.4.1 to read as follows:*

"The difference between the costs and revenues of the Top-up Manager is payable to or recoverable from relevant Users in the Top-up Recovery Period in accordance with this paragraph 6.4."

*Amend paragraph 6.4.3 to read as follows:*

"Each relevant User shall pay to the Top-up Manager, or (as the case may be) the Top-up Manager shall pay to each relevant User, a charge ("**Top-up Neutrality Charge**") calculated:

- (a) in respect of each Day in the Top-up Recovery Period, as the Top-up Daily Recovery amount divided by the sum of all the relevant UDQOs for the Day multiplied by the sum of the relevant Users relevant UDQOs for the Day:
- (b) in respect of calendar month after the Top-up Recovery Period, as the Top-up Recovery Adjustment Amount for the preceding month divided by the aggregate sum of all relevant Users' relevant UDQOs for each Day in the Top-up Recovery Period multiplied by the sum of the relevant User's relevant UDQOs for each Day in the Top-up Recovery Period."

*Insert new paragraph 6.4.4 to read as follows (and renumber existing paragraph 6.4.4 as paragraph 6.4.5):*

"The top-up Neutrality Charge shall be payable by the Top-up Manager to the User where it is negative and by the User to the Top-up Manager where it is positive."

Signed for and on behalf of Transco.

Signature:

**Tim Davis**  
**Manager, Network Code**

Date:

**Gas and Electricity Markets Authority Response:**

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0472**, version **3.0** dated **12/04/2002**) 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 **3.0**.

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.