Final Modification Report
Modification Reference Number 0234

This draft 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:

As a result of AQ Review 97, a number of M numbers had their AQ's increased which significantly increased the portfolio size. After checking the new proposed AQ's it became apparent the increases were incorrect and therefore they were appealed. Subsequently successful appeals reduced the AQ's to the correct level.

As a result of the incorrect portfolios during October, November and December - the period before appeals reduced portfolio sizes - daily demand attribution was also incorrect, therefore exposing Shippers to the System Marginal Price.

After reconciliation for this period the increased gas volumes are returned, however the actual costs incurred are lost because gas is reconciled at the System Average Price.

If the change is not made Shippers will incur a loss for reconciled gas volumes for the difference between the System Marginal Price and System Average Price.

Also gas was purchased on a daily basis and as reconciliation did not occur for up to six months after the day, Shippers have incurred significant cash flow implications.

This is a retrospective Modification Proposal because of bona fide incorrect AQ's which inflated daily demand. This caused gas inputs to fall below daily tolerance allowances therefore incurring System Marginal Prices.

The purpose of the Proposal is to recover costs from Transco due to the SMP exposure as a result of the erroneous AQ's from October 97.

2. Transco's opinion:

The Proposer raised the Modification Proposal in April 1998 in response to their exposure to SMP charges arising during the AQ 97 process, in particular the costs incurred over 16 and 17 December 1997.

Transco does not support the Proposal for the following reasons:

1. The Proposal retrospectively seeks to reimburse Shippers for failure to balance, thereby undermining the integrity of the balancing regime by reducing incentives to balance accurately.

2. Commercial decisions knowingly taken by a Shipper should not be underwritten by Transco or other Shippers, particularly as the reasons for those

decisions may be driven by a number of additional factors. Transco's advice to Shippers at the time was to balance to their allocations, and Shippers exercised their choice whether to do so or not. All were provided with the same information by Transco.

3. By not balancing to their allocations, Shippers may have contributed to the balancing actions taken on the days in question. The high SMP prices set on the 16 and 17 December 1997 are not attributable to AQ 97, but rather a feature of the balancing regime. Recovery of costs should not therefore be aimed at the AQ 97 process.

4. The Proposal seeks to breach Transco's neutrality with regard to energy balancing. Transco currently cannot earn money through neutrality and therefore should not be exposed to costs.

5. In addition to the mitigation strategies put in place to reduce the impact of AQ 97 on Shippers, Transco has already made an ex - gratia payment of £2.7m in respect of extra costs incurred. Further payment in relation to this issue is not justified.

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

Transco considers that this Proposal would not facilitate the relevant objectives, specifically:

Condition 7. Relevant Objective (a)

Any Modification Proposal which seeks to retrospectively reimburse a Shipper who takes a decision not to balance on a day and thereby, in part, cause unnecessary balancing actions, cannot contribute to the efficient and economic operation of the System. Indeed this may encourage other Shippers not to balance if they believe there is a prospect of cost recovery.

Condition 7. Relevant Objective (c)

By having the risks of Shippers who incur SMP charges underwritten by other parties, prudent Shippers who choose to fully fund their balancing costs are placed at a commercial disadvantage. Any such advantage would run counter to the securing of effective competition.

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

a) implications for the operation of the System:

Any action which encourages Shippers not to balance may cause unnecessary and potentially costly actions by Transco to reduce System imbalances.

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

There would be no direct development and capital cost implications associated with this 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:**

As the Proposal is aimed at recovering costs from Transco, this section will not apply.

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

Transco is unaware 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 Proposal challenges neutrality retrospectively and as such may lead to further piecemeal undermining of Transco's contractual position.

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

Transco is unaware of any development implications for computer systems.

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

There are no direct implications for Users unless the SMP costs are recovered through neutrality.

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

Transco is unaware of any implications for these 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:**

Transco has not been informed of any consequences on the legislative and regulatory obligations of implementing this Proposal. The retrospective nature of the Proposal and it's undermining of Transco neutrality may diminish the integrity of the contractual relationship.

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

Advantages:	- Shippers will recover SMP costs associated with actions taken on the 16 and 17 December 1997.
Disadvantages:	- Retrospective adjustments weaken incentives for Shippers to balance. - Shippers who cause costs on the System are protected to the extent that commercial decisions are underwritten by other parties. - Transco neutrality is undermined.

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. Quantum Gas Management (QGM) and Vector Gas support the Proposal. BP Gas, United Gas Services, British Gas Trading (BGT) and Alliance Gas do not support the Proposal. Eastern Power and Energy Trading (EPETL) does not state whether or not it supports the Proposal, but believes that to only address those costs identified by the Proposer would be inappropriate.

QGM and Vector Gas believe that incorrect base data as a result of the AQ 97 process caused demand attribution for the 16 and 17 December 1997 to be incorrectly inflated.

United Gas Services notes that Shippers were made aware of the problems associated with erroneous AQs and were capable of calculating the additional exposure they may have faced. United Gas Services and BGT note that it was possible for Shippers to mitigate their SMP risk by balancing to the allocations provided by Transco. Moreover, BGT states that the vast majority of Shippers did so, and United Gas Services believes that failure to do so can only be seen as a commercial decision by that User.

United Gas Services believes that it would be inappropriate if those companies that did seek to mitigate the SMP risks associated with erroneous AQs should then compensate those Users that took a commercial decision not to mitigate such risks. Similarly, BGT states that it would be giving completely wrong signals to the industry if compensation was made to Shippers who had deliberately chosen not to balance and thereby threatened to undermine the balancing regime by their actions. BGT states that this Proposal could be seen as discriminating against those Shippers who acted in accordance with Network Code rules. BP Gas believes that if a Shipper makes a commercial decision on a day not to balance, any perceived loss should not be reimbursed by the shipping community or Transco. Moreover, Alliance Gas states that the Network Code rules are clear on the matter of deliveries for the NDM portfolio and any Shipper making a commercial decision to do otherwise is aware of the circumstances which will follow.

BGT states that approval of this Proposal could be seen as encouraging Shippers to seek retrospective changes to the Network Code in order to protect them from commercial exposures. Also, Alliance Gas believes that the Proposal undermines the balancing rules currently contained within the Code.

BGT and EPETL state that costs other than SMP were incurred by Shippers who took action to mitigate the effects of inflated AQs. EPETL identifies these costs to be the purchase of expensive, short term winter gas to enable Shippers to balance to Transco's NDM forecasts. EPETL believes that to only address costs which were incurred by those Shippers not balancing to Transco's forecasts, which in turn may have led to increased balancing actions and cost to the community, would be inappropriate. United Gas Services states that Transco exposed companies to additional gas costs when extra gas was purchased at SAP on 16 and 17 December 1997, but only recovered at the end of the month at 30 day SAP. United Gas Services states that reconciliation is not price neutral to Shippers and believes that Transco should reimburse the losses that some Shippers have incurred through additional reconciliation costs.

Transco Response:

QGM and Vector Gas assert that incorrect base data as a result of the AQ 97 process caused demand attribution for 16 and 17 December 1997 to be incorrectly inflated. However, the effect of inaccurate AQs on a Shipper's demand attribution varies according to the extent of under or overdeeming of all other Shippers' portfolios and the progression of a Shipper's AQ appeals relative to all others. A scaling factor ensures that the sum of Shippers' allocations does not exceed total NDM demand in each LDZ.

Transco acknowledges that problems associated with the AQ 97 process resulted in Shippers and Transco incurring additional costs. In recognition of this, Transco has compensated Shippers with an ex-gratia payment of £2.7m, and regards this payment as a settlement of issues arising from AQ 97. Transco does not accept that it exposed Shippers to additional gas costs on 16 and 17 December 1997 as the high System prices experienced were a feature of market conditions on the day. Issues associated with actions taken on 16 and 17 December 1997 have since been addressed by the industry in order to reduce the possibility of such circumstances recurring.

Transco considers that the other points made in representations largely reflect its own views as set out in this Modification Report.

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

This Proposal is not required 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 3(5) of the statement, furnished by Transco under Standard Condition 3(1) of the Licence:

This Proposal does not affect the methodology established under the above condition.

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

Transco does not support implementation and accordingly no works programme is provided.

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

Transco does not support this Proposal and accordingly no implementation timetable is provided.

16. Recommendation concerning the implementation of the Modification Proposal:

Transco recommends this Proposal is rejected.

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 direction from the Director General in accordance with this report.

19. Text;

As Transco recommends rejection, no legal text is provided.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date: 19/2/99

Director General of Gas Supply Response:

ANNEX

Restrictive Trade Practices Act - Suspense Clause

For the purposes of the Restrictive Trade Practices Act 1976, this document forms part of the Agreement relating to the Network Code which has been exempted from the Act pursuant to the provisions of the Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996. Additional information inserted into the document since the previous version constitutes a variation of the Agreement and as such, this document must contain the following suspense clause.

1. Suspense Clause

1.1 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 shall not come into effect:

(i) if a copy of the Agreement is not provided to the Director General of Gas Supply (the "Director") 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 Director 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 paragraph 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996.

provided that if the Director does not so approve the Agreement then Clause 1.2 shall apply.

1.2 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 shall not come into effect until the day following the date on which particulars of this Agreement and of any such arrangement have been furnished to the Office of Fair Trading under Section 24 of the Act (or on such later date as may be provided for in relation to any such provision) and the parties hereto agree to furnish such particulars within three months of the date of this Agreement.