Modification Report

Network Code Modification Reference Number 0314

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:

The following proposal is brought forward following discussions in the BC99 / RGTA process. Details of the workgroup discussion are provided in the Modification 0314 workgroup report dated 14 May 1999. Further detailed development of the proposal has occurred through legal drafting sessions held at Stratford and London.

System Entry Capacity will be defined for each Aggregate System Entry Point (ASEP). Capacity will be made available in monthly tranches, (corresponding to calendar months) for the next gas year as Monthly System Entry Capacity (MSEC). If it is forecast for a day that the System can accept deliveries of gas above the level of Monthly System Entry Capacity entitlements held by shippers then additional daily capacity will be made available on D-1 as either Daily System Entry Capacity or Interruptible System Entry Capacity.

Monthly System Entry Capacity and Daily System Entry Capacity will be firm capacity services. Monthly System Entry Capacity provides an entitlement to deliver gas into the System at the ASEP on each day within the relevant period and also to receive a share of any applicable daily revenue share within that period. Daily System Entry Capacity provides an entitlement to deliver gas into the System at the ASEP for a single gas day only. Interruptible System Entry Capacity provides a right to deliver gas to the System at the ASEP on a gas day provided that the System can accept the delivery flowrate.

Firm capacity entitlements allow a shipper to deliver gas to the System or to receive a rebate payment in the event that a System constraint prevents them from fully using their entitlement. The use of interruptible capacity may be curtailed at any time and no rebate payment will be due, although the shipper will not be invoiced for the capacity that has been curtailed.

Capacity entitlements entitle the holder to deliver a quantity of gas to the System during the gas day at a rate not exceeding 1/24th of the daily amount per hour.

For the gas year 1999/2000 the aggregate amount of Monthly System Entry Capacity that Transco will make available will be set according to the average demand forecast for each month under seasonal normal weather conditions (SND). The available System capacity will be shared between entry points according to an agreed methodology. Transco's preference is for the derivation of the aggregate SND capacity level and its allocation by entry point to be the subject of a separate methodology statement. However, Transco has agreed to incorporate this methodology within the Network Code and this will be the subject of a separate modification proposal.

The initial allocation of Monthly System Entry Capacity will be carried out using an auction based market mechanism. The detail of the mechanism does not form part of this proposal but implementation of this proposal is contingent on there being an agreed methodology. This methodology will be the subject of a separate modification proposal.

If any Monthly System Entry Capacity remains unsold then it will be made available subsequently for purchase as Outstanding System Entry Capacity up until three days before the start of the month in which the capacity can be used.

Daily firm and interruptible services will be made available through auction mechanisms similar to those established under Modification 0273. It is proposed that the reserve prices for the daily services be set to provide incentives to acquire Monthly System Entry Capacity. The calculation of these reserve prices does not form part of this proposal.

If the amount of firm capacity sold for a day is less than the level declared as available Monthly System Entry Capacity under the SND methodology then there is a much reduced likelihood that interruption will actually be called at that ASEP. The amount of interruptible capacity made available will then be the difference between the level of capacity sold for the day and the anticipated gas nominations.

Where the amount of firm capacity sold at an ASEP is equal to or greater than the declared SND level then if there is additional capacity available then this may be released in addition to any use-it-or-trade-it interruptible capacity. Once allocated there will be no distinction in the rights conferred to a holder of interruptible capacity derived through either process.

A capacity surrender mechanism will be introduced to allow shippers to offer their firm capacity entitlements back to Transco during the D-1 period. This will provide a mechanism to manage forecast constraints. Shippers will be able to offer to release their firm capacity at a price that reflects the value they place on it. If Transco identifies a potential constraint during the D-1 period then it may accept capacity offers from shippers to achieve a reduction in the level of firm capacity entitlements held and thereby reduce the risk that firm entitlements will be curtailed later.

If a System Entry constraint occurs after the D-1 buyback period then, where applicable, Transco will reduce interruptible capacity entitlements before taking actions affecting firm capacity entitlements. Interruptible capacity will only be reduced if a physical constraint is forecast, that is, the anticipated gas flow rates will lead to a situation where excessive pressures would arise. If it is necessary to reduce the expected flow rate to a level below that which is supported by 'firm' capacity holdings, Transco will take actions to reduce the capacity entitlements held by shippers. The mechanism will scale back each shipper's firm capacity holding to a level sufficient to relieve the constraint. Where firm entitlements have been scaled back under this mechanism a rebate payment will become due. The rebate payment level will be set so that there is an appropriate incentive for Transco to buyback capacity during D-1 if a constraint is forecast.

The action taken by Transco to deal with a System Entry constraint will align the aggregate capacity entitlement (commercial) with the System capability (physical). If the System cannot accept the expected gas flow rate and the aggregate capacity entitlements held by shippers are less than or equal to the System capability then Transco will issue a Transportation Flow Advice notice at the ASEP and inform shippers that a System Entry constraint exists.

A Shipper's available capacity entitlement for the consideration of any Overrun Quantity will be the aggregate of their Monthly System Entry Capacity, Daily System Entry Capacity, Interruptible System Entry Capacity and any traded quantities in respect of each ASEP for each gas day taking into account any scaling of capacity entitlement that may have been applied. If the quantity of gas allocated to a shipper at an ASEP is greater than that shipper's available capacity entitlement at that ASEP, the excess quantity will be determined as an Overrun Quantity and will be subject to an overrun charge.

The overrun charge rate will provide an incentive for shippers to acquire capacity. This will protect the entitlements held by shippers within a regime where the aggregate level of entitlements for an ASEP is linked to the System capability. The overrun charge will be linked to market mechanisms and will be determined using a 'greater of' rule to ensure that it provides a sufficient incentive.

Revenues from Daily System Entry Capacity, Interruptible System Entry Capacity and overrun charges arising as a result of a Shipper having a negative available capacity at an ASEP may be shared between Transco and holders of Monthly System Entry Capacity through a new capacity neutrality mechanism.

Transco shall receive 20% of the total revenue from Daily System Entry Capacity and Interruptible System Entry Capacity services at the ASEP and bear 20% of the cost of capacity buyback or rebate payment subject to a collar and cap. The revenues will be accounted for in a Transco incentive account. The remaining 80% of the revenues will be allocated to a Shipper incentive account. Transco initially proposed that there should be a specific shipper incentive account for shippers holding Monthly System Entry Capacity at each ASEP. A number of shippers suggested that it would be preferable to operate a single shipper incentive account for all ASEPs. Transco therefore provided drafting to facilitate either option within the modification proposal.

The net revenue received by Transco through the incentive mechanism taking into account; capacity surrender charges, capacity rebates paid, revenue from Daily services and revenue from Interruptible services will be subject to a collar and cap. The annual amount will be split into monthly incentive collars and caps. Each month will be considered as discrete and there will not be a carry forward of incentive sums. In the event that for a month the Transco incentive account exceeds the level of the revenue collar or cap the excess amount will be returned to holders of Monthly System Entry Capacity in proportion to their aggregate capacity holding across the System. Following the end of each incentive month Transco will issue "capacity neutrality" invoices.

All existing capacity registrations and registered trades will be terminated with effect from the date that the new regime outlined in the modification proposal is implemented.

2. Transco's opinion:

Transco supports the principle of a better definition of capacity entitlements. To achieve this definition the level of capacity that is made available on a long term basis must reflect the capability of the System to accept gas delivered at each entry point throughout the year. This capability is affected by the availability of plant, the pattern in which shippers wish to deliver gas and the demand level. The most significant of these factors is System demand. Transco therefore proposes the use of seasonal normal demand levels as a basis for calculating monthly firm capacity availability.

Transco agrees that additional daily services should be provided and that a price based allocation method similar to that currently being used for Daily System Entry Capacity should be used. A reserve price should be retained to provide shippers with an incentive to procure long term capacity rights in preference to daily capacity up to the level of long term availability.

The use of a capacity surrender mechanism is an appropriate method by which shippers can value System Entry Capacity. However, Transco is concerned that lack of liquidity in the capacity market may create opportunities for extreme prices that do not reflect shipper costs plus a reasonable premium. Transco does not believe it is appropriate for it to develop a within day market mechanism as this may deter the development of a screen based capacity trading system along the lines of the OCM.

Transco understands shippers' concerns regarding the provision of capacity but maintains that it has always endeavored to maximise the available capacity. However, in the context of a revised regime where the amount of capacity available for sale is finite, Transco accepts that the community would like to see an incentive mechanism in place to ensure that capacity is made available. Given that any incentive should provide the opportunity for reward as well as risk, an amendment to the Transco PGT Licence is required to facilitate this reward potential. An amendment is also required to facilitate the return of revenue to shippers through the benefit share mechanism without this revenue being classed as transportation revenue for formula purposes. Ofgem have now issued a PGT Licence amendment consultation, part of which proposes changes in this area.

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

The changes to the capacity regime will better facilitate the following relevant objectives:

- Condition 7 (1)(a) - "*the efficient and economic operation by the licensee of its pipe-line system*" and
- Condition 7 (1)(c) - "*the securing of effective competition between relevant shippers and between relevant suppliers*".

The key features of the proposals that will help achieve these relevant objectives are as follows:

Better definition of entry capacity will facilitate a closer match between the physical capability of the System and the entitlements held by shippers. This is achieved by linking availability to a seasonal profile. Greater certainty regarding shippers' requirements to use capacity services will facilitate more efficient scheduling of system operations including the planning of maintenance activities;

Greater certainty of capacity service will facilitate trading of capacity rights so that individual shippers are better able to match their requirements to capacity holdings;

The management of entry capacity constraints through a capacity mechanism will reduce the risk to shippers of untargetted smeared energy balancing neutrality costs arising from the use of the flexibility mechanism to alleviate System entry transportation constraints;

Introduction of incentives for Transco to make capacity available may lead to more efficient operation of the pipeline system.

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

a) implications for the operation of the System:

The use of a capacity regime to relieve constraints will represent a change from current arrangements. The operational processes and the computer systems used by Transco will be required to change as Transco will be using the capacity regime in place of the Flexibility Mechanism to relieve constraints. Changes will be necessary to procedures used for the management of constraints. The use of the capacity regime to manage constraints will increase the necessity for accurate and timely entry flow nominations from Shippers.

b) development and capital cost and operating cost implications:

Development costs will be incurred as a new computer system is required to manage the registration of shippers' capacity holdings and to provide a robust vehicle for the market based allocation mechanisms proposed for the allocation of capacity entitlements. In addition, a new billing system is required to provide functionality to deliver Entry Capacity invoices with sufficient supporting data to permit shipper validation.

Costs may be incurred as part of any capacity incentive mechanism placed on Transco.

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:**

The cost of developing a new system to manage the sale, registration and billing for entry capacity services is being met from a budget designated for system development.

Capacity incentive payments made by Transco to Shippers will represent an additional cost. No payments will be made by Transco into the incentive mechanism beyond the agreed collar.

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

A change to the mechanisms by which capacity is made available is expected to require changes to price regulation. This is particularly the case if there is a change from the use of cost reflective pricing for entry capacity.

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 implementation of a capacity incentive on Transco will increase the level of contractual risk to which Transco is exposed. If Shippers perceive Transco to be capable of exploiting the regime at their expense then there is a risk to information flows and a further risk of increased balancing costs and capacity constraint costs. The structure of the incentive regime may lead Transco to pursue a particular strategy and this might lead to claims that Transco is not operating the System in an economic and efficient manner as required by its PGT licence.

Rules are proposed in respect of the incentive mechanism to protect the cash flow of all participants. These rules limit the participation of a shipper in the capacity auction mechanisms in the event that the shipper has exceeded Network Code credit limits.

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

The current capacity registration systems within AT Link will be replaced by a new system to provide the new capacity services. Computer systems both within Transco and Users must be adapted to introduce this modification. Transco has investigated the effect of these changes to Transco systems and in summary has identified the following system changes:

a) Establishment of a new system to manage the sale and registration of capacity services.

b) Invoice production changes requiring new invoices and new charge types.

The computer systems of Users have been built to interface directly with the Transco UK Link systems. Users will need to adopt new or revised systems to accommodate the change. Users have also adopted automatic means of calculating and checking charges invoiced by Transco for capacity services. In the future, the equivalent charges and credit invoices will be generated from a new system and new and revised charge items will be billed by Transco. This may necessitate the development of new or revised systems by Users for invoice validation. Users have been informed of these requirements through the UK Link committee and Transco will be making appropriate amendments to the UK Link manual to take account of the changes brought about by this proposal.

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

Users will have an opportunity to acquire entry capacity services to more closely match their requirements through the year by the purchase of monthly capacity tranches. Capacity services will be better defined and thus trading will be facilitated. This should lead to a much higher level of liquidity in any secondary market for entry capacity than that provided by the present mechanisms. There will be a greater availability of daily capacity services that will further provide shippers with an opportunity to match their capacity holdings to their requirements for a day. The availability of interruptible services encompassing the spirit of use-it-or-trade-it will discourage 'hoarding' of firm capacity.

Users will have greater certainty of firm service prior to usage. The incentive mechanism should lead to a close match between the System capability and the capacity entitlements held by shippers. A robust overrun incentive will encourage shippers to obtain capacity prospective of gas flow and thereby protect the entitlements of all firm and interruptible capacity holders.

System Entry constraints will normally be managed through the capacity regime that will reduce the risk that shippers face of incurring smeared energy balancing neutrality charges. The revenues generated from the sale of daily capacity services and the costs of managing System entry constraints will be targeted to those using entry capacity services.

A capacity surrender mechanism will permit shippers to offer capacity back to Transco at a price that reflects the value they place on that capacity.

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:

Improvements in certainty of service may reduce the incidence of unexpected constraints. This reduces the likelihood that large flow rate reductions will be required at input points. The use of shippers' system entry capacity entitlements to manage gas flow constraints will potentially reduce accuracy in targeting Terminal Flow Advice (TFA) notices to individual sub-terminals. Procedures for managing constraints will be changed to reflect the implementation of this proposal.

The use of an auction mechanism to allocate System Entry Capacity may lead to an over or under recovery of agreed formula revenues for system entry. Any such over or under recovery would be passed forward into the 'k' factor in the pricing formula and be corrected by adjustment to transportation charges.

If efficiency benefits are achieved then these may be passed through to 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:

An amendment to Transco's PGT licence will be required to facilitate the upside of the capacity incentive mechanism and the capacity revenue sharing process. An amendment will also be required to facilitate the introduction of auctions for System entry capacity services.

These proposals may change the relationship between Transco and each User to the extent that Transco may be trading in a capacity market both with and against Users of its System.

The determination of the amount of capacity to be made available as Monthly System Entry Capacity and the reserve price to be used in the sale of this capacity will be the subject of an agreed methodology. The methodology is to be established within the Network Code and will be the subject of separate modification proposals.

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

Advantages

Provides greater certainty of service.
Facilitates trading of firm capacity services.
Incentivises Transco to provide capacity in response to Users' requirements.
Introduces market mechanisms for the management of constraints.

Removes cost of constraints from energy balancing neutrality.

Disadvantages

Requires creation of capacity market mechanisms.
Transco incentive may introduce undesirable conflicts

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

Transco received 18 representations and has included representations received after the close out date in this report. The issues raised within the representations are grouped below under the following headings;

General comments
Capacity service types
Capacity availability methodology
Daily service mechanisms
Daily service availability
Within day mechanisms
Capacity trading
Incentive mechanism parameters
Incentive mechanism sharing
Limit on capacity allocation
Termination of existing bookings
Constraint processes and scale back
Overrun charges
Invoicing arrangements

General comments
A number of respondents indicated that they do not support the proposal within the proposed time scale. A common theme within these responses is the timetable to achieve the proposed changes, the number of associated issues still outstanding, the complexity of the RGTA regime and the need to conduct the auction of Monthly System Entry Capacity for 1999/2000.

There were several references to the types of auction that might be used to allocate Monthly System Entry Capacity. As the auction mechanism does not form part of this proposal those views have not been included in this report. A separate consultation will be conducted on the structure of the auction to be used to allocate Monthly System Entry Capacity. The views expressed within the responses to this modification proposal will be considered along with any other representations that are made during the auction consultation.

Capacity service types
There is universal agreement on the types of capacity service proposed, Monthly, Daily (firm) and (daily) Interruptible. In addition, there is general support for a D-1 capacity surrender mechanism to allow Transco to 'buy-back' capacity. Eastern notes that in future it would like

to see other tranche lengths available. Transco foresees that in the short term the secondary market will provide a mechanism for capacity holders to aggregate or dis-aggregate Monthly System Entry Capacity into other tranche lengths.

Capacity availability methodology

A majority of the shippers considers that the methodology for determining the availability of Monthly System Entry Capacity should be contained within the Code and not within the PGT licence. Shippers consider that this will provide greater transparency to the methodology and give shippers a greater opportunity to influence changes to the methodology.

In addition, there is a concern that the duration of maintenance activities will be overstated in order to maximise the opportunity for Transco to gain revenue through the incentive mechanism operating around daily services. The solution proposed by shippers is that the mechanisms used to determine the planned duration of maintenance activities should be made available for validation by Ofgem.

Transco has indicated that the proposed methodology will use maintenance plans that have been prepared in accordance with Section L of the Code. The maintenance activities used to determine the availability of Monthly System Entry Capacity will be detailed in the (April) maintenance plan that is published by Transco in accordance with Code. This is described in the legal drafting. In addition to any Code provisions regarding the planning and scheduling of maintenance activities, Transco has an overarching Gas Act obligation to operate the network in an efficient and economic manner.

Transco notes that a number of responses expressed concern regarding the linking of several entry points into the 'THREAD' ASEP. Transco will consider these views in the formulation of the capacity availability methodology.

Transco intends that the methodology for determining the availability of Monthly System Entry Capacity and the structure of an auction to allocate this capacity will form a separate modification proposal which if accepted, will place the methodology and the auction mechanism definition within the Code.

Daily service mechanisms

There is general agreement regarding the timing of the D-1 mechanisms. There is also support for an indicative use-it-or-lose-it estimate to be provided at 12:00hrs D-1.

Aquila states that where bids are accepted for daily capacity services these should be charged on the basis of 'pay-as-bid' to avoid the posting of 'spoof' bids. Aquila proposes that there should be daily reporting of the results of the auction processes. Transco does not support pay-as-bid charging as it considers that this method may allow greater opportunity for dominant participants to adversely influence the market. In the current arrangements Interruptible and Daily capacity are sold using a clearing price auction and Transco proposes that this arrangement, which has operated satisfactorily to date, should be adopted for the similar services within the RGTA regime.

BG Storage argues that the use of storage services, particularly LNG, is too unpredictable for shippers to be able to determine their requirement for capacity at 13:00hrs on D-1. Transco believes that a potential requirement to use capacity can be identified at D-1 and if shippers perceive a need to secure capacity then they may participate in the D-1 mechanisms. The clearer definition of capacity services that is a key feature of the RGTA regime will facilitate secondary trading of capacity in cases where there is a mismatch between those holding capacity and those wishing to use it. The concern of BG Storage that there will be insufficient capacity available may be addressed in two ways. Firstly through the incentive mechanism to make the maximum amount of capacity available for daily and interruptible services at an ASEP and secondly through the setting of reserve prices for such daily services. Transco believes that the former is achieved by the incentive mechanism. The latter issue of reserve prices is the subject of a separate consultation.

Daily service availability

Enron is concerned that Transco will have an incentive to make available additional capacity in a way that benefits other parts of BG plc, notably BG Storage and BG Gas Services. Transco has no intention of operating the capacity regime in a way that would breach its licence and Gas Act obligations.

Enron and BGT are concerned that Transco will have an incentive to make additional capacity available in a way that maximises revenue. It is suggested by these respondents that additional capacity should be made available in proportion to the amounts of capacity made available in the initial allocation (Enron) or according to the 1998 ten year plan terminal monthly throughput proportions (BGT). BGT do not accept the concept of related ASEPs. However, this view ignores the fact that a system constraint may exist within the network and may be common to two or more ASEPs.

Transco cannot support either of these suggestions if a capacity incentive mechanism is in place. The daily system capability will be evaluated for all ASEPs and the incentive mechanism will encourage Transco to maximise the availability of capacity at all ASEPs. If ASEPs interact and an amount of system capacity must be allocated between them, the D-1 bidding processes allow shippers to indicate their preference for that allocation. The drafting of the incentive mechanism is that where ASEPs do interact the bids placed for them will be considered together and capacity allocated according to the same price ranking criteria.

Scottish and Southern Energy (SSE) proposes that Transco should not sell daily or interruptible capacity in excess of the maximum pipeline capability. Transco agrees that for firm capacity this is valid but that the incentive mechanism will mitigate against this situation arising. If Transco has released firm capacity entitlements that are in excess of the physical capability then there is an increased risk that a constraint will occur and a subsequent scale-back will be required. The costs incurred in scaling back will exceed the additional revenues gained through selling capacity that was not available. In the case of interruptible capacity it may be argued that a modest degree of overselling above the system capability for the day is desirable to facilitate maximum utilisation of the available system capability. The interruptible capacity entitlements will only be scaled back if the expected physical flows cannot be accepted.

SSE also suggests that Transco should not allocate interruptible capacity until daily firm capacity has been allocated. Transco agrees that this approach has some merit and the initial proposal offered a timetable that identified this sequence. However, during the final business rules workstream and the detailed discussions of the drafting, concern was expressed regarding these timings and a majority of those present argued that the processes should be run concurrently and concluded earlier. Transco has modified the drafting to reflect the majority view.

Transco believes that the effect desired by SSE is achieved through the incentive mechanism. The highest revenue is likely to be achieved through the sale of firm capacity and so the incentive operates to allocate capacity to this type of bid first.

The proposal is that Transco may sell additional interruptible capacity beyond the 'use-it-or-lose-it' level providing that the aggregate of firm registrations is at least equal to the level declared as available to be held as Monthly System Entry Capacity. This further incentivises the allocation of firm capacity before interruptible in order that this additional capacity may be released. However, Transco recognises that in some cases a shippers requirements for monthly capacity will not match the declared availability as future delivery patterns may change. In such circumstances this may mean that interruptible capacity in inappropriately restricted to UIOLI and the need to incentivise monthly firm bookings may be inappropriate. In view of this Transco proposes that as an interim measure (prior to the development of a within day market) interruptible capacity is made available over and above UIOLI when 90% of declared monthly capacity in aggregate is held either as monthly or daily firm capacity.

BGT, BG Storage, Dynegy and Enron argue that the rules should ensure that quantities of interruptible capacity are maximised at all terminals and that allocation is on a consistent basis. Transco believes that the proposed drafting achieves this.

Within day mechanisms

Several shippers responded that they would prefer to have a within day mechanism to access additional capacity or to offer capacity surrender. SSE notes that such within day mechanisms could be provided via a screen based capacity trading system and the service could 'easily be facilitated by the OCM Market Operator'.

The business rules developed within the RGTA capacity workstream stated that the mechanisms proposed by Transco would facilitate the release of daily capacity and capacity surrender until such a market became available.

Transco believes that it would be inappropriate to extend the proposed Transco/shipper mechanisms to form within day tools as this is likely to create a 'Capacity Flexibility Mechanism'. Transco considers that such a development would be a retrograde step and reintroduce the undesirable features of a mechanism without achieving the full benefits of a market. Transco believes that if there is sufficient support for a within day capacity market then a market operator will provide a service. If a facilitated market becomes available it may be appropriate for Transco to trade in that market and to suspend the Transco mechanisms. It is anticipated that such a development would require a Code modification.

Transco is also concerned that in the short term there may be a lack of liquidity in any within day market. This would be exacerbated while the situation exists that only a limited number of shippers have the flexibility in their gas purchase contracts to turn down significant volumes of gas at short notice. Transco believes that illiquidity in the market could lead to excessive prices and windfall gains for individual shippers, which are not reflective of shipper costs. The use of a scale back mechanism within the context of a regime designed to incentivise the use of capacity surrender on D-1 is an appropriate tool for managing within day capacity adjustments at this stage of development of the new capacity arrangements.

Capacity Trading

SSE observes that in the 0273 mechanism shippers cannot trade capacity with each other. The proposed RGTA regime will permit shippers to trade firm capacity and the facility for shippers to register such trades will be provided for the purposes of calculating each shipper's available capacity for the determination of capacity overruns. It is not possible to provide a facility to specifically track interruptible capacity entitlements through trades as the amount of the entitlement and the charge that will be made for it will vary if the interruptible capacity is scaled. There is clearly a difficulty as the amount of the entitlement that is registered as being traded may be affected by scaling factors. All classes of capacity including registered trades will be considered for the determination of a shipper's available capacity.

Incentive mechanism parameters

A majority of shippers stated that the parameters of the Transco incentive mechanism should be included within the Network Code and not within the PGT licence.

Transco has circulated an alternative drafting for Section B2.11 that includes the Capacity Incentive Percentage and the Annual Capacity Incentive Amount Limit within the Code. A modification to the PGT licence is required to facilitate the retention of the upside of a capacity incentive but Transco is prepared to include the parameters of the incentive within the Network Code.

There is general agreement that the parameters proposed, 20% Transco share revenues/cost and monthly incentive collar/caps derived from £5million per annum, are appropriate. A number of shippers request that the operation of the incentive is kept under review and if necessary that the parameters be modified.

Powergen argues that the annual incentive amount should not be split into 12 monthly incentives as historically constraints have occurred over distinct periods. Transco agrees that in the past the likelihood of constraints occurring was considerably greater during the summer months and this was the driver for the implementation of modification 0331 for the summer of 1999. Under the proposed regime with an SND based allocation methodology there will be a much closer link between the capacity held by shippers and the capability of the system. This will lead to a situation where the likelihood of a constraint affecting a particular ASEP is similar for all ASEPs and for all months. It is therefore appropriate to divide the annual incentive amount into 12 equal monthly incentive amounts.

Incentive mechanism sharing

There is mixed opinion regarding the sharing of the neutrality amount. Aquila and Eastern support the drafting that proposed targeting of both costs and revenues to the shippers holding Monthly System Entry Capacity at each ASEP. Eastern argues that costs should be targeted to their source in order to discourage manipulation of constraint situations.

National Power, Total and Enron support a sharing of costs and revenues in accordance with each shipper's proportion of Monthly System Entry Capacity across the whole system, arguing that a constraint may not be attributable to input activity at a specific ASEP.

The majority of those that expressed a view suggested a hybrid solution that would target revenues to the ASEP but share costs across all holders of monthly capacity.

Notwithstanding the two alternatives already proposed, Transco sees considerable merit in the hybrid solution. Targeting benefits to the ASEP will encourage shippers to provide accurate information regarding likely nominations as this will maximise the potential for release of daily services at that ASEP. This treatment delivers some benefit to firm capacity holders in the event of use-it-or-lose-it capacity being sold. Sharing costs to all monthly capacity holders at System level recognises the interdependent nature of ASEPs and significantly reduces the risk that shippers at one particular ASEP will face high neutrality charges as the result of a constraint. This approach also recognises that the incentive mechanism will encourage Transco to find the least cost solution to a constraint condition and that such actions may involve costs at ASEPs other than the primary source of the constraint. The legal drafting has been modified to reflect the hybrid approach.

20% limit on capacity allocation

Quantum states that despite the use of market based allocation mechanisms and the 'use-it-or-lose-it' regime the allocation of monthly capacity must not result in one party obtaining more than 20% of any ASEP capacity if that ASEP is oversubscribed. Transco does not support the inclusion of such restrictions as this conflicts with the purpose of introducing market based solutions. The inclusion of use-it-or-lose-it provisions provides adequate protection against 'capacity hoarding'.

Termination of existing bookings

Quantum does not support the end dating of existing capacity bookings when the RGTA capacity regime is implemented. Quantum argues that if existing bookings are terminated then they should be compensated for the loss of St. Fergus shoulder month bookings that they consider valuable. Transco considers that the introduction of the RGTA regime brings fundamental changes to the nature of the capacity services and the means of accessing those services. In the new regime the existing concept of annual capacity tranches will no longer exist. If existing capacity bookings are not terminated but are ring-fenced within the new regime then the availability of capacity within the RGTA regime will be reduced. There is a high likelihood that for most ASEPs and for most months there will be no capacity available for auction as existing bookings are not limited to the physical capability of the system. Transco does not believe that compensation should be paid for bookings that are terminated to facilitate the introduction of a more efficient capacity regime.

Constraint processes and scale-back

A number of shippers agree that the revised drafting issued subsequent to the Stratford workshop delivers an appropriate level of incentive for Transco to utilise capacity surrender offers during D-1 rather than imposing scale-back of capacity within day. (The revised drafting introduced a market based mechanism for determining the rebate price rate that included the value of capacity surrender offers at the most expensive ASEP). Mobil believes that in addition to providing an appropriate incentive for Transco it also delivers an incentive for shippers to make capacity surrender offers.

Mobil supports the revised drafting proposed for Section I and notes that the increased multipliers applied will incentivise Transco to scale capacity rights appropriately. Alliances agree that the hierarchy of tools available to manage constraints is correct.

Powergen strongly opposes the use of a scale back mechanism and believes that it should be abolished. Transco stressed repeatedly throughout the RGTA consultation that a form of scale back mechanism must exist to maintain System safety in situations where the commercial mechanisms have failed to deliver an appropriate resolution of a constraint.

BGT suggests that Transco should face 100% of the costs of scaling back as the only way that Transco is incentivised not to use this mechanism. Transco believes that this is invalid as it would construct a regime in which shippers may 'create' constraints through nomination behavior while avoiding any consequence of the constraint arising. The Transco proposal provides a sufficient incentive for both Transco and shippers to achieve an appropriate level of capacity entitlement at D-1.

Aquila and SSE express concerned that scaling back of capacity entitlements should not begin at 15:00hrs on D-1 as demand updates following shortly after this time may alleviate the need for Transco scaling actions. Transco believes that the operation of the incentive mechanism is such that it is unlikely to begin scaling actions until a greater degree of certainty of need can be obtained. This is normally unlikely to be available before DFNs are received at around 20:00hrs D-1. However, if before this time it is clear that scaling will be necessary Transco believes that it is appropriate to give maximum notice in order that shippers may make alternative arrangements.

Enron is concerned that Transco will discriminate in the location of scale-back, that scale-back will be arbitrary and that compensation is non-market based. Transco does not agree. A need for scaling back firm capacity entitlements will be driven by physical limitations of the System and the need to maintain safe operation. In the event that there is a choice of actions that could resolve a constraint then the operation of the incentive mechanism will identify a lowest cost solution. Transco believes that within an agreed incentive mechanism, action on the basis of market signals is appropriate. Shippers are able to signal the market value that they place on capacity at an ASEP by making capacity surrender offers during the D-1 period. It is these offers that will be used in the calculation of any rebate payment.

Overrun charges

A number of shippers argue that the overrun charge rates are too high and that this will result in gas being locked offshore. SSE argues that the proposed rate is too high and that shippers will be unable to avoid overruns as shippers have no control over gas flows to the system. SSE argues that the overrun should be determined via a market mechanism and suggest that an appropriate link is to the long term auction price. Powergen is concerned that the overrun charge rates may not be sufficiently high. Mobil, Alliance, Total and Elf agree with the proposed method.

Enron, Eastern, BGT and BG Storage propose a low cost overrun regime where an ASEP is not constrained. National Power and others argue that the overrun element linked to the gas SMP spread introduces an element of uncertainty into the overrun charge. Eastern proposes that if this element of the overrun charge is likely to become effective for a day that Transco should notify shippers in order that they might consider their overrun exposure.

Aquila supports the proposal that overrun charges are treated as transportation revenue. BGT questions whether overruns should form part of transportation revenue. Enron and SSE believe that the inclusion of an element linked to the D-1 capacity selling price will incentivise Transco to withhold capacity in order to establish a high overrun rate. Transco does not support this view as Transco will not receive additional benefit from income as a result of overrun charges since this is transportation revenue within the current formula.

Ofgem clearly indicated that the concept of a low cost overrun was unlikely to be acceptable within a regime structured on defined capacity entitlements. Transco believes that the availability of interruptible capacity services provides appropriate opportunity for shippers to mitigate against overrun risk.

SSE has concerns that the entitlement of a capacity holder at an ASEP is to deliver a quantity of gas to the system at 1/24th flow rate. SSE claims that Shippers have no control over the rate of flow of gas into the system. Transco is surprised to learn that shippers do not have arrangements in place to ensure that gas is delivered in an efficient manner.

Transco has proposed an overrun mechanism that is linked to market signals. The link to D-1 capacity mechanism prices provides a link to the short term value for capacity at the ASEP and operates in addition to the long term value derived from the daily rate for MSEC. Transco believes that an overrun element linked to gas costs will protect shippers holding firm capacity in the event that the benefits that could accrue from 'dumping' gas to the system exceed the costs that would arise as a result of the other overrun elements operating. However, Transco recognises the fact that the use of SMP means that shippers cannot "price" the overrun in a system buy bid and have amended this to be 1.5 times SAP to dis-incentivises "dumping" of gas into the system but allows for delivering gas without capacity when the system will benefit.

Transco does not support the argument that the risk of overrun charges will 'lock gas offshore'. Shippers may mitigate the risk of incurring overrun charges through the purchase of daily services. Dynegy suggests that interruptible services should have a low reserve price so that shippers are encouraged to acquire these services. The issue of reserve prices for interruptible services is to be the subject of a separate consultation.

Invoice arrangements

Some shippers express concern regarding the arrangements for invoicing the proposed services and the time scale to implement changes to billing procedures. Transco has sought to provide information to shippers through dedicated RGTA billing workstreams and through the UK Link Committee forum. It has not been possible to finalise the proposals for billing arrangements as these are dependent on the definition of services and the structure of the incentive mechanism. Transco is endeavoring to provide much greater clarity with the introduction of a NTS Entry Capacity Invoice type. This, with the information to be made available through the new entry capacity system, will enable shippers to validate invoices.

Further details regarding file types will provides as soon as possible.

Note: Transco has removed the Capacity Neutrality Financing Adjustment from section 2.11.8 as this has proved overly complex to administer.

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) of 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:

Finalise system design requirements,
Evaluate systems changes within Transco and Shipper systems,
Design and build systems,
Test revised systems with Transco and Shippers,
Test linkages between systems,
Implement training programs within Transco and Shippers,
Amend systems to reflect observations during training and testing,
Re test systems,
Implement changes.

A programme plan has been issued.

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

Conditional approval of modification - August
Pricing methodology consultation - August
Issue new invoicing file formats to Shippers - August
Systems and connectivity testing - August/September
Shipper training on new systems - August/September
Issue pricing consultation notice - September
Allocation of Monthly System Entry Capacity - September
Open bid window for daily capacity services - 23/9/99
Termination of all existing entry capacity registrations and trades - 30/9/99
Implementation of new entry capacity regime - 1/10/99.

Shipper training on new invoice - October
New capacity invoices issued - 4/11/99

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

Transco recommends implementation of this proposal subject to the conditions listed in Section 20 of this report.

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 Director General in accordance with this report.

19. **Text:**

The attached draft text describes the revised capacity regime for modifications 314 and 350 to be set out in sections B, I, L, Q, S and Transition Document.

20. **Conditionality**

Transco considers that the implementation of this proposal requires a number of other related matters to have been resolved prior to 1 October 1999. There preconditions are as follows;

i) establishment of a set of capacity auction rules governing the sale of Monthly System Entry Capacity and the approval of a subsequent Network Code modification describing the mechanism by which shippers will participate in the auction.

ii) establishment of a methodology for the determination of Monthly System Entry Capacity availability. (SND agreed for 1999/2000) and its approval through a Network Code modification.

iii) modifications to the Transco PGT Licence conditions as required to implement an auction of entry capacity and to facilitate the reward potential of the proposed capacity incentive mechanism.

iv) completion of a pricing methodology consultation and agreement that the proposal to implement relevant changes will not be vetoed.

v) implementation of changes to the Transportation Statement to establish the relevant reserve prices for capacity auctions.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Director General of Gas Supply 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 **0314**, version 1.1 dated **01/09/99**) be made as a modification to the Network Code conditional upon the matters specified in section 5.20 of this report.

Signed for and on behalf of the Director General of Gas Supply.

Signature:

Director of Trading Arrangements

Date: 1/9/99

The Network Code is hereby modified, with effect from 1st october, in accordance with the proposal as set out in this Modification Report, version **1.1**.

Signature:

Process Manager - Network Code
Transco

Date: 020999

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.