

**Final Modification Report**  
**Modification Reference Number 0364**

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:**

This modification Proposal seeks to remove On-the-day Commodity Market (OCM) set-up costs placed on Shippers as a result of Modification 0313 until such time as the charges can be properly debated, justified and validated.

**2. Transco's opinion:**

The Reform of the Gas Trading Arrangements (RGTA) process revealed a desire for the introduction of an OCM which allowed Shipper to Shipper trading of gas as opposed to the Flexibility Mechanism which allowed only Shipper to Transco trading of 'physical' gas. This market provides a new trading tool designed to enhance cost effective Shipper balancing whilst at the same time increasing efficiency which might be expected to reduce Transco's system balancing role and costs. Transco believes that it is important that there is an appropriate apportionment of the costs associated with the introduction of the OCM, and that there is no reason why Transco should be the sole bearer of such costs. Transco has committed considerable resources and incurred significant costs associated with its own systems development to support the implementation of RGTA. This, however, leaves some of the costs associated with the appointment of the Market Operator which Transco believes should be recovered from Users.

Modification 0313 addressed recovery of the £550,000 one off payment made by Transco to EnMO (OCM systems operator) as a contribution on behalf of Users towards the set-up costs of the OCM which included the following elements:

EnMO to Transco "systems integration fee" - £450,000

Contribution in lieu of individual Trading Participants joining fees- £100,000

The £450,000 is the payment required by EnMO as part of its tender submission to build and operate the OCM. This tender submission, along with others, was assessed by a Tender Evaluation Panel (TEP) which included representatives from Transco, Shippers and Ofgas. The remit of the TEP was to provide a recommendation to Transco as to the most economically advantageous proposal and EnMO were chosen by the TEP in mid May 1999, although at this stage the method of funding the £450,000 had not been agreed and as such the TEP were unaware of how any costs would be treated. As the tender process requires that the content of each submission remains confidential no further detail of the tenders can be provided, indeed further breakdown of this figure can not be given without the written agreement of the tender party. These funds were invoiced to Transco on 1st October 1999 and have been paid

in accordance with Transco's normal credit terms ahead of any cost recovery.

A further £100,000 was included in the cost recovery mechanism following agreement with Ofgas. This payment constituted an aggregate contribution from Users that would enable EnMO to waive their proposed Trading Participant joining fees. Transco believes that Ofgas's intention was to provide a fair allocation of costs between Shippers and Transco, having paid due regard to Transco's contribution to EnMO set-up costs and Transco's direct systems costs.

Although the issue of set-up cost recovery was debated during the initial workgroup discussions in support of Modification Proposal 0313 and referred to in the Workgroup Report, Draft Modification Report, and Final Modification Report, the principle and method of recovery were not included in the legal drafting prior to the issue of the Final Modification Report. The Modification Proposal 0313 draft legal text in support of this cost recovery was detailed in version 4.0 of the draft legal text issued on 6th August 1999. In their decision document "The New Gas Trading Arrangements: A decision document" Ofgem deemed that Transco should be allowed to recover these costs as they "are not covered under Transco's price control."

As part of Modification 0313 Transco also undertook to maintain and update the Flexibility Mechanism for a minimum of 14 months following the introduction of the On-the-day Commodity Market (OCM) as a contingency for market and/or systems failure of the OCM. As such, costs for the provision of the Flexibility Mechanism will remain with Transco for the foreseeable future.

Given the above Transco believes that it should be allowed to recover the £550,000 contribution to payments made to EnMO in respect of provision of the OCM.

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

This Modification is not thought to impact the relevant objectives

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

**a) implications for the operation of the System:**

None

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

As Transco has already met the costs involved the removal of the charges placed on Shippers to recover these costs would increase Transco's attributable development costs for Modification 0313.

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 part of Modification 0313 Transco has and will continue to absorb all the costs associated with amendments to its systems to support the 1st October Reform of the Gas Trading Arrangements (RGTA) changes. The Ofgem Direction resulting from the Modification 0313 process stated that the costs involved in this Proposal are not considered by Ofgem to be part of Transco's current price control and, as such, Transco should be allowed to recover these costs.

The Draft Modification Report for Modification Proposal 0313 recommended that these costs be recovered through the new Energy Balancing incentive mechanism by adjusting the parameters to enhance Transco's position and that these costs be recovered over a twelve month period starting on the 1st October 1999. However, in the final report it was considered that the method of recovery should be more transparent and visible to Shippers thereby enabling preservation of the incentive parameters advocated by Ofgem. It was therefore submitted in version 4.0 of the legal text that the recovery of these costs be arranged through a new adhoc invoice item introduced alongside those developed as a result of the new incentive mechanism.

The method of recovery of these costs included in the legal text for Modification 0313, therefore, allows for £750 per day (for a two year period) to be reclaimed from Shippers in relation to their User Proportion, User Proportion being defined in the revised Section D 3.4.2 as:

"the sum of the relevant UDQIs and the relevant UDQOs for that User, divided by the sum for all relevant Users of their relevant UDIs and relevant UDQOs."

This methodology is the same as that used to allocate the majority of costs and revenues arising from operation of the Network Code. Transco, therefore, considers this method to be the most appropriate means of allocating the recovery of these costs.

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

The proposed changes are not anticipated to have price regulation consequences.

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

The proposed changes are not anticipated to have an effect on the level of contractual risk to which Transco is exposed.

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

The removal of these charges will require changes to the processes and procedures to produce the adhoc invoice introduced for the OCM. As such, some changes to the Transco computer systems will be required to remove this item from the invoice. Users systems are thought to require some modifications to accept an amended invoice structure.

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

This Proposal would remove the charges currently being levied on Users to enable Transco to recover funds paid to EnMO to help establish the OCM.

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:**

The proposed changes are not anticipated to have an effect on 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:**

The proposed changes are not anticipated to have an effect on these areas.

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

**Advantages**

- i. Suspends recovery of costs from Users pending review of these costs.

**Disadvantages**

- i. Increases industry time and costs spent on discussion of areas recently subject to the Modification process,

- ii. Would require Transco to fund these costs despite the Ofgem direction that these costs do not form part of Transco's price control and should therefore be recovered from Users.

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

Fourteen Representations were received in response to the Draft Modifications Report. A number of these Representations were received after the close out date. Transco has endeavoured to include and address these. All representations received supported the Modification Proposal.

**11.1. OCM set-up costs recovery not debated in open forum and no opportunity for consultation / representation.**

Yorkshire Energy Limited (YE), Scottish and Southern Energy plc (S&SE), Total Gas Marketing Limited (TGM), Enron Europe Limited (Enron), ExxonMobil Gas Marketing (EMGM), Alliance Gas Limited (Alliance), Shell Gas Direct Limited (Shell), Conoco UK Limited (Conoco), British Gas Trading Limited (BGT), BP Amoco (BPA), TXU and Quantum Gas Management (Quantum) commented that the issue of cost recovery had not been adequately debated in open forum. Conoco also state that they understood that *“the first time it (cost recovery by Transco) became public knowledge was when the final Modification Report (313) was sent to Ofgem. There was thus no opportunity for consultation.”*

Dynegy UK Limited (Dynegy) comment that *“shippers were asked to make representations on the RGTA modifications whilst they were incomplete and before the OCM charge had been included”*. TXU comment that the *“charge and method of recovery were only included in the final draft of the legal text which accompanied the final modification report issued after the deadline for Shipper representations.”* Alliance considers that the issue of OCM set-up costs *“was raised on a number of occasions by shippers”* but *“was consistently parked despite shippers’ requests to the contrary.”*

TGM comment that *“The community were excluded from the decisions made in respect of the funding of the OCM set up costs. Agreement was reached exclusively between Transco and Ofgem as to how these would be imposed upon the community.”* YE is concerned that the application of the charges was *“the result of a deal between the transporter and regulator”* and constitutes a *“serious abuse of process”*.

**Transco’s Response:**

Transco considers that the issue of OCM set-up cost recovery was raised and debated during the workgroup discussions in support of Modification Proposal 0313 without reaching agreement. The issue was, however, referred to in the Workgroup Report, Draft Modification Report, and Final Modification Report. S&SE, Dynegy, National Power plc and Eastern Power and Energy Trading Limited made representations on this issue as part of the Modification process for Modification 0313.

The Modification Proposal 0313 draft legal text in support of the cost recovery was detailed

in version 4.0 of the draft legal text issued on 6th August 1999. Although this date was after the closing date for Shipper representations for inclusion in the Final Modification Report it was also 24 days before the date Ofgem signed the Final Modification Report for 0313.

In this context, Transco considers that Shippers did have opportunity to express their opinion on the proposed final legal text prior to Implementation. Indeed Shell commented in its Representation that it took up this opportunity by writing *“to Ofgem, on 25th August 1999, bringing to its attention this and other changes that were made after the consultation.”*

Transco further considers that, given the timescales imposed by the RGTA process, it communicated the issues as fully as possible and facilitated the maximum opportunity for Shippers to submit representations on this issue as part of Modification 0313.

### **11.2. Inclusion of initial Shipper joining fees.**

EMGM, Conoco, Shell and BGT, comment on the inclusion within the set-up costs of the estimated joining fees for the first twenty Shippers signing up to the OCM. Conoco consider that the method of recovering these fees means that these fees *“have been smeared across all shippers regardless of whether they are using the OCM.”* EMGM add that this *“discriminates against larger shippers who have signed up to the OCM”*

BGT can *“see no justification for “smearing” costs relating to software licences, contractual and credit documentation set-up, site survey and training.”* BGT further considers that *“This represents a clear cross subsidy between shippers”* and *“£5000 is nominal and would not act as a barrier to entry.”*

Shell considers *“the costs are the product of a cross subsidy between different shippers, discriminate therefore between shippers and are contrary to the objective of encouraging competition between shippers.”*

However, National Power plc commented that as the OCM *“was also set up to facilitate shipper to shipper trading.... it could perhaps be argued that the £100,000 .... should be borne by shippers.”*

S&SE asks whether or not there *“has been any validation of such costs, particularly given that EnMO expects there to be 40 subscribers to the OCM by the New Year.”*

### **Transco’s Response:**

The OCM was partly intended to be a replacement for the Flexibility Mechanism and it is Transco’s understanding that Ofgem’s intention, in requesting Transco to include these sums within the set-up cost recovery, was to alleviate a possible barrier to entry for smaller Shippers into the market by having the initial joining fees waived and the costs recovered elsewhere.

### 11.3. Role of the Tender Evaluation Panel (TEP) and access to information from the tender process.

Quantum commented that it did not have a representative on the IMO TEP and, therefore, *“were not in possession of all relevant facts”*. As such it consider that it was *“effectively discriminated against”*. Quantum further requests that should the industry *“go through a similar process in the future, then such data must be released from a confidentiality undertaking immediately a company is selected.”* TGM finds it *“unacceptable”* that *“there has been no breakdown of the detail covering the breakdown of the systems integration fee.”*

BGT considers that *“this was a Transco tender for the appointment of a market operator and that the TEP had no role to play in determining that shippers should pay for interface costs”*.

YE *“understand”* that costs and recovery of these costs *“was excluded from the discussion within the Tender Evaluation Panel when Shipper representatives were present.”*

#### **Transco’s Response:**

Transco considers that it acted as the contracting entity in facilitating the tender to appoint EnMO as the OCM Market Operator. As with any procurement process, there are strict confidentiality provisions to follow and these apply prior to, during and after the tendering programme. As such, details of any of the tender bids are confidential and not available for release into the public domain.

The TEP was formed as a cross-section of the industry to act on behalf of all parties in recommending a tenderer. The TEP was tasked with selecting the most economically advantageous bid most compliant with the OCM business rules and used several measures to reach its conclusions, including the cost of the bid to the industry. The TEP did not consider the basis for any cost recovery mechanism.

### 11.4. Transco allowed revenue and provision of the Flexibility Mechanism.

YE, TGM, S&SE, Enron, Shell, TXU, Alliance, BGT, Dynegy and Quantum make reference to Transco’s allowed revenue resulting from the 1997 Monopoly and Mergers Commission (MMC) report. Quantum considers that the *“MMC report allowed Transco significant sums for system development including AT-Link and the Flexibility Mechanism. Transco has already recovered these monies”*. Further, the *“OCM replaced the Flexibility Mechanism therefore Transco should incur no additional costs.”* National Power plc commented that the *“role of the OCM first and foremost was to replace the flexibility market”*.

TGM *“remains convinced that Transco’s existing Price Control Formula provides funds to enable Transco to discharge its responsibilities to maintain and develop its system balancing obligations via the flexibility mechanism or its replacement, the OCM.”*

Enron *“do not agree”* with the Ofgem decision that the *“costs are not covered under Transco’s price control”* and also comment, in regard to the retention of the Flexibility Mechanism, that *“it seems implausible that the costs of maintaining a contingency system are the same as maintaining an operational system.”* Dynegy also questions the savings made by

Transco *“from losing the flexibility mechanism”*.

Enron and Shell are against Transco being allowed to recover the set-up costs as this implies a re-opening of the price control. Enron comments that *“there has been no examination of Transco expenditure on information systems and operational interfaces in comparison to the expenditure assumed in the price control formula and the 1997 MMC report.”*

YE comments that Ofgem had given *“assurances that they would ensure Transco pay, consistent with the price formula”*.

### **Transco’s Response:**

As part of Modification 0313 Transco has and will continue to absorb all the costs associated with amendments to its systems to support the 1st October Reform of the Gas Trading Arrangements (RGTA) changes. The Ofgem Direction resulting from the Modification 0313 process stated that the costs involved in this Proposal are not considered by Ofgem to be part of Transco's current price control and, as such, Transco should be allowed to recover these costs.

In its document “The New Gas Trading Arrangements: A decision document (September 1999) Ofgem states one of the objectives of the reforms as *“Reform of the wholesale gas trading arrangements”* to *“ensure that customers are able to benefit fully from the introduction of competition in gas supply”*. One of the key aims was to provide a new trading tool designed to enhance cost effective Shipper balancing and not merely a replacement for the Flexibility Mechanism.

As part of Modification 0313 Transco also undertook to maintain and update the Flexibility Mechanism for a minimum of 14 months following the introduction of the On-the-day Commodity Market (OCM) as a contingency for market and/or systems failure of the OCM. As such, costs for the provision of the Flexibility Mechanism will remain with Transco for the foreseeable future.

Given the above Transco believes that it should be allowed to recover the £550,000 contribution to EnMO’s costs which Transco incurred on behalf of the industry.

### **11.5. PGT licence Condition 7.**

Dynegy considers that *“Ofgem must make a decision about this modification on the basis that it better facilitates the relevant objectives set out in Standard Condition 7 of PGT licences”*.

### **Transco’s Response:**

Transco considers that the introduction of the OCM better facilitates the Relevant Objectives and believe that Ofgem have acknowledged this in directing the implementation of Modification 0313. The key issue is then the apportionment of costs generated by such implementation, and Transco believe that Ofgem will have considered this issue before approving Modification 0313.



## 11.6. Effect on Transco's Energy Balancing Incentive mechanism

Alliance suggests the method applied to recover the set-up costs *"has impacted on Transco's Gas Balancing incentives scheme"* by reducing the initial £2million to £1.75million. YE also comments on the issue of asymmetry in the Energy Balancing Incentive and the effects of cost recovery.

### Transco's Response:

The legal text version 4.0 which accompanied the Final Modification Report detailed that the recovery of these costs be arranged through a new adhoc invoice item. Subsequently the User Proportion of this charge now appears as a separate item on the Adhoc Energy Incentive Invoice. Therefore, the Energy Balancing Incentives and the cap and collar figures have remained as originally intended and consulted upon. However, whilst the cap on Transco's benefit is set at £2 million per year there are not enough days in the year to make this a theoretical possibility given that the maximum daily incentive reward is £4000.

Transco considers that the cost recovery element achieves transparency and avoids any confusion over the OCM cost recovery effects which might have occurred should more sophisticated adjustments been made to modify the Energy Balancing Incentive parameters.

## 11.7. Recovery of costs from all benefiting Users and Transco's proportion of these costs.

Alliance, BGT, YE, EMGM and Shell, comment on the "smearing" of OCM set-up costs across all Users in accordance to their share of System throughput. BGT *"believes that it is clear that Transco should contribute to, if not bear a significant share of, these costs"* bearing in mind the level of Transco's OCM participation. Alliance also note *"that not all shippers are OCM participants, but will still be liable for a proportion of the overall charges."*

### Transco's Response:

Transco has deployed significant resources, and incurred major costs in facilitating the RGTA changes. Transco considers that the mechanism for recovery of the OCM set-up costs is justified on the grounds that the intention of the OCM is to reduce industry balancing costs. Consequently, costs resulting from the establishment of the market should be recovered from all those benefiting from the market i.e. the entire shipping community.

Transco's only role in the OCM is as the residual System balancer. Transco is, in effect, using the OCM on behalf of Shippers to maintain System Balance and not for its own benefit.

## 11.8. Transco / Ofgem withheld information from the community.

TGM comments that it *"would appear that following the appointment of EnMO that the*

*OCM set up costs were clearly known to Transco and Ofgem” but that “this information was withheld from the community until the latter stages of the RGTa process”. As a result it considers that “there was insufficient time to discuss and gain acceptance and understanding of the validity of the charges.”*

**Transco’s Response:**

The announcement that EnMO had been selected by the TEP was made on 4th June 1999. On 18th June 1999 Transco issued the Draft Modification Report for Modification 0313 which identified *“Initial systems to Market Operator interface set up costs for the OCM, .... to be in the region of £500,000 dependent on the number of market participants.”* As such Transco does not consider that at any time it unreasonably withheld information in regard to the appointment of EnMO, the OCM set up costs, or indeed its recommendation as to how such costs should be recovered.

**11.9. Fair allocation of costs.**

S&SE comments that it *“would welcome explanation of Transco’s statement “Transco believe that Ofgem’s intention was to provide a fair allocation of costs between Shippers and Transco, having paid due regard to Transco’s contribution to EnMO set-up costs and Transco’s direct systems costs.” Does this mean that Transco has paid additional funds to EnMO (on top of the £550,000) to help establish the OCM?”.*

**Transco’s Response:**

Transco, under the terms of the appointment contract, is unable to detail any payment it has made to EnMO to help establish the OCM without the prior consent of EnMO to such release.

**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. Program of works required as a consequence of implementing the Modification Proposal:**

Implementation of this Proposal would require changes to the format and calculation of the OCM cost recovery item on the balancing incentive adhoc invoice.

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

No timetable provided

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

Transco recommends that this Modification Proposal is not implemented.

**17. Transco's Proposal:**

Transco proposes that this Modification Proposal be rejected.

**19. Text:**

None supplied.

Signed for and on behalf of Transco.

Signature:

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

Date: 13/12/99

**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 **0364**, version **1.0** dated **13/12/99**) be made as a modification to the Network Code.

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

Signature:

**Director of Transportation Regulation**

Date:

The Network Code is hereby modified, with effect from \_\_\_\_\_, in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:

**Process Manager - Network Code**  
**Transco**

Date:

## **ANNEX**

### **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.