Draft Modification Report
A method of Long Term Capacity Allocation
Modification Reference Number 0508

Version 1.0

This Draft 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

This proposal sets out a process whereby Users are able to purchase long term entry capacity rights in the NTS to suit their portfolio and business requirements. All prices will be ring-fenced and not adjusted as a consequence of subsequent auctions or price controls. This proposal provides clear signals of future capacity requirements to Transco and underwrites any required incremental investment.

Each year Transco will sell Long Term Entry Capacity (LTEC) in quarterly segments, Quarterly System Entry Capacity (QSEC), commencing with year Y+1 (i.e. from 1st October 2002) for the period required by the Users. Upon completion of the auction process, any unsold capacity beyond Y+1 will be carried to the next annual auction.
All capacity will be offered on the basis of an end of day quantity from which is derived an equal hourly flow rate against which Users have purchased a right to flow gas. Payment, as now, will continue to be due the month after the month of potential use and will be charged on a pence per kWh basis.

As with other capacity products, Users will have the opportunity to trade their QSEC at any time. The payment liability will remain with the primary purchaser regardless of secondary market trading. However, any User liabilities associated with entry capacity management will take into account net capacity holdings and shall reflect the effect of capacity trades.

Transco will be exposed to the full cost of any buy-back liability arising out of any failure to accommodate flows of Users QSEC at any ASEP.

Overview of the capacity allocation process

Prior to the commencement of each annual LTEC allocation, Transco will issue a schedule of reserve prices by Aggregate System Entry Point (ASEP) associated with output measures to be specified in its Gas Transporter licence, together with an indicative cost schedule for the provision of capacity in excess of up to [50%] of the output measures. The reserve price will be based upon Transco’s regulated revenues allocated between terminals according to long run cost. The available capacity for each quarter, which is the output measure less previously sold capacity, will also be published. All of this available capacity will be offered in the auction. Users will have a period of [2 weeks] to submit their QSEC requirements by quarter and ASEP to Transco. Upon closure of the submission period Transco will aggregate the Users QSEC demand by ASEP and publish the outcome of the round:

· if aggregate demand by ASEP in any quarter is less than or equal to the available capacity then all capacity demanded for that quarter will be offered at the reserve price;

· if aggregate demand by ASEP is greater than the available capacity for any quarter Transco will recalculate the cost of providing the additional incremental capacity demanded at each ASEP for the period(s) over which the incremental capacity is required. The cleared price for these periods will be the aggregate of the reserve price plus the cost of providing the incremental capacity spread over the volumes bid for these periods.

In addition Transco will provide details of the proposed investment programme by cost, location and timing.

A further round will take place within [7 days] during which Users will then have the opportunity to confirm their acceptance of these prices by leaving their bids unchanged, or to submit revised requirements by volume and ASEP.

This process will continue until, in response to Transco's latest demand / price schedule, either,

(i) Users make no further adjustments to their requirements or ,

(ii) The aggregate volumes and the auction clearing prices have not changed by more than [+/-X%] in any quarter at
any ASEP or,

(iii) After [6] iterations or if the process is diverging, mathematical principles are available to ensure that the process is closed out.

In conjunction with this LTEC allocation process there are other associated issues that require consideration. These issues are common to any long-term allocation process and include

· Agreement on satisfactory credit / security arrangements with Transco.
· The application of overrun to be adapted to reflect the new entry capacity regime
· Transparency of Transco's cost modelling processes and determination of prices
· Arrangements for shorter-term capacity products, which may include MSEC, DSEC, MISEC and DISEC.

However, Transco can only sell these short-term products for year Y+1 when the auction for that year is complete.

This proposal does not require any changes to entry capacity trading arrangements.

2. Transco's Opinion

Transco does not support implementation of this proposal because it believes that the relevant objectives contained in its licence would be furthered to a greater extent if Modification Proposal 0500 is implemented.

Transco has previously indicated that the necessary lead time to build new capacity is around three years. For periods of less than three years Transco's ability to provide additional capacity is limited to marginal gains through reconfiguration of existing plant. In such circumstances a process that rationed excess demand to meet limited availability might be expected. However, this proposal will oblige Transco to satisfy demand for additional capacity regardless of its ability to deliver. Transco believes that it potentially creates a misleading signal for Users about system capability and whilst a contractual right to capacity might be delivered there could be no underpinning gain in physical capability to deliver the contracted quantities. In these circumstances constraint costs would be expected to increase, the payment of which is shared amongst Users and Transco.

Transco does not believe that it is appropriate or efficient for Users to be required to fund additional capacity that they have not demanded. Under Modification Proposal 0508 this could arise over several dimensions. On a locational basis the proposal is that all investment above baseline is equally funded at all the locations at which additional capacity has been demanded. The requirement thus makes it possible for additional costs to be signalled at Bacton and St Fergus, for example, and for Users at both Aggregate System Entry Points to be required to share the bundled costs. A temporal dimension is also evident whereby a User demanding Capacity in a particular year may be required to share the costs of providing additional capacity in another year. This outcome arises from a requirement to aggregate all incremental costs signalled across all years of an allocation.

Transco believes that Ofgem has given a clear indication that a requirement will be placed upon Transco to hold back a proportion of Entry Capacity for short term allocation. This Proposal does not facilitate holding back capacity for release ahead of the relevant Gas Year, and Transco is concerned that this is inconsistent with the Licence obligations Ofgem has indicated it would expect to propose, and which Transco has accepted in principle.

Ofgem has also made it clear that Transco's Licence should be amended such that it faces a proportion of buy back costs. Transco is concerned that this Modification Proposal seeks to pass all buy back costs to Transco, which would be inconsistent with the anticipated Licence provisions.

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

The changes to the Entry 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*"

The key features of the proposals that will help achieve this relevant objective are as follows:

Long term capacity allocation will enable contracting for a level of entry capacity that should satisfy Users needs and will be offered at prices that closely match Transco's costs. The process will also enable Users seasonal demand to be signalled in a manner that supplements the present planning process.

Effective competition is enhanced by offering long term Entry Capacity to all Users on a non-discriminatory basis and by utilising credit arrangements that maintain low barriers to entry. However, no provision for holding back Entry Capacity might be considered to increase barriers to entry for new entrants.

The proposed allocation process will provide a frequent (annual) offering of Entry Capacity that enables a Users capacity portfolio to be managed incrementally and for it to consist of capacity commitments for varying periods of time.

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

a) implications for the operation of the System:

In terms of the appropriate size of the system the signals received from a long term allocation process might lead to a changed investment programme to more closely match Users needs.

b) development and capital cost and operating cost implications:

Development costs will be incurred as a new computer system might be required to manage the allocation process. In addition billing systems will need to be adapted to provide functionality to reflect new charge types for entry capacity.

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:

It is anticipated that any additional System Operator costs incurred as a result of implementing this Proposal would be accounted for under the proposed internal cost incentive scheme, as set out in Ofgem's final proposals for the System Operator incentives.

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

Pricing Methodologies will be required to determine the appropriate reserve prices and incremental costs to be used in a long term capacity allocation. The methodology will also need to describe the interaction of new investment, re-phased planned investment and previously funded investment.

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 Modification Proposal 0508 would reduce the level of contractual risk to Transco for provision of long term Entry Capacity because the proposition is that all additional investment should be fully funded by Users.

In terms of the proposed buy back incentive the proposal will increase risk to Transco by making it 100% liable for all buy back costs arising from curtailment of incremental capacity. All risk arising from sales of baseline Capacity, rolling MSEC and Daily System Entry Capacity will be shared between Users and Transco.

Rules are proposed to limit the participation of a User in any capacity allocation mechanism in the event of that User exceeding Network Code credit limits.

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

Systems developments will be required to implement this proposal, and it is anticipated that these could not be delivered until 2003. Capacity registration and billing processes will remain largely unchanged though they must be adapted to reflect the introduction of new categories of capacity and release over extended durations.

7. The implications of implementing the Modification Proposal for Users

Users will have an opportunity to acquire entry capacity for periods of up to 25 years. Users will be able to hold a mix of long and short term capacity in a manner that reflects their risk profile. Users will also have opportunities to demand and receive capacity in excess of the Baseline Capacity signalled in Transco's licence. Users will be required to fund capacity above baseline during the period for which they have demanded additional incremental capacity.

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

A process that enables supply of capacity to be adjusted to meet demand should over time tend to reduce the incidence of unexpected constraints. This should enable more efficient planning of gas supplies by producers and more predictable operation for Terminal Operators.

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 GT licence has been agreed in principle to reflect the System Operator Incentives that are required to enable Transco to respond to long term investment signals. If implemented this Proposal would require that incentive to be reconsidered. In particular the Proposal is based on an obligation to provide additional Entry Capacity rather than reflecting risks and rewards specified in an incentive. An obligation to provide capacity may change the relationship between Transco and each User, in particular where curtailment of firm capacity is required.

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

Advantages:

- Supply can be expanded to meet demand.
- More opportunities to obtain Entry Capacity
- Users can obtain a mix of short and long term Entry Capacity to reflect each Users risk.

Disadvantages:

- More complex systems are required to manage the Entry Capacity process.
- Poor fit with Licence proposals, particularly requirements to hold back capacity and entry capacity incentives.

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

Representations are now sought.

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

Implementation is not required to enable Transco to comply with any legislation.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Transco is unaware of any such requirement.

14. Programme of works required as a consequence of implementing the ModificationProposal

Write legal text
Generate system design requirements,
Evaluate systems changes within Transco and Users systems,
Design and build systems,
Test revised systems with Transco and Users,
Test linkages between systems,
Implement training programs within Transco and Users,
Amend systems to reflect observations during training and testing,
Re test systems,
Implement changes.

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

Ofgem decision expected - mid 2002
System Implementation 1 February 2003
Effective date 1 April 2003

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this Modification Proposal.

Transco's alternative Modification Proposal is 0500 - 'Long Term Entry Capacity Allocations'

17. Text

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: