Modification Report
A method of Long Term Capacity Allocation
Modification Reference Number 0508
Version 1.0

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

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. The Modification has been developed through the workstream process; details of the workstream discussions are provided in the Modification 0508 workstream report dated 20 February 2002. The changes to the business rules that have arisen from the development process are summarised at the end of this section.

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 (at a level of granularity as small as 1 day if required).

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 and up to a level of approximately 150% of the output measures. The reserve price will be based upon Transco's regulated revenues allocated between terminals scaled in proportion to an assessment of long run marginal 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 [seven 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 [six] 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.

Summary of Developments through Workstream Discussions

- Capacity sales have been given a defined end date of 25 years to facilitate systems development.
- The bid window has been reduced to one day, with fours days between rounds for Transco to review prices, to enable the auctions to close in a reasonable timescale.
- The methodology for calculation of prices between rounds has been developed further and is detailed in the business rules.
- The closure rules have been amended such that the auction would close if prices (only) have changed by less than 2.5% and the divergence process has been developed, full details are included in the business rules.
- The proposal has been developed such that constraint management costs are now shared between Transco and Users for Baseline Capacity, but any costs associated with constraints arising from incremental capacity would be funded by Transco.
- Other aspects of the proposal, such as credit arrangements, overrun charges and shorter term auctions have been developed in line with Modification 0500.

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, or severely limited changes in the physical infrastructures capability to deliver the contracted quantities. In these circumstances constraint costs might be expected to increase, the payment of which is shared amongst Users and Transco.

Transco considers that it may not be appropriate or efficient for Users to fund additional capacity for which they might not have requested via the bidding process. Under Modification Proposal 0508 this could arise from other locational and/or temporal issues . On a locational basis the proposal defines that all investment to support capacity provision above baseline is funded by Users at all the locations at which additional capacity has been demanded. The requirement thus makes it possible for additional capacity 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. Similarly from a temporal perspective, a User requesting 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 proposed, 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. Although the Modification has been amended such that Transco and Users share buy back costs for constraints associated with Baseline Capacity, Transco is still concerned that this Modification Proposal would be inconsistent with the proposed Licence provisions, in its treatment of constraints associated with incremental capacity.

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

The proposed changes to the Entry Capacity regime will be expected to better facilitate the following relevant objective:

- 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 could be offered at prices that closely reflect 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 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.

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 to facilitate the first allocation process under this Proposal 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 expected to be identified in Transco's GT 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 long term capacity to be allocated is expected to facilitate more efficient planning of gas supplies by producers.

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

Amendments to Transco's GT Licence have been proposed by Ofgem to reflect the System Operator Incentives that incentivise Transco to respond to long term investment signals. If implemented this Proposal may 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 for Users to obtain Entry Capacity
Users can obtain a mix of short and long term Entry Capacity to reflect each User's 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)

Thirteen representations were received:

Agip (UK) Ltd (Agip)
British Gas Trading Ltd. (BGT)
Phillips Petroleum Company Ltd. (Phillips)
TotalFinaElf Exploration Ltd. (TFEE)
TotalFinaElf Gas & Power Ltd. (TFE G&P)
Innogy (Innogy)
Statoil (UK) Ltd (Statoil)
Exxon Mobil Gas Marketing (EMGM)
Shell Gas Direct (SGD)
TXU Europe Energy Trading Limited (TXU)
Powergen UK Plc. (Powergen)
BP Gas Marketing Ltd (BP)

BG Gas Services (BGS)

Two respondents (TFE G&P, TFEE) support the proposal.
Five respondents (Agip, Phillips, Statoil, Powergen, BP) did not express a definitive position in respect of this modification proposal.
Six respondents (BGT, TXU, SGD, EMGM, Innogy, BGS) do not support the proposal.

11.1 Long Term Auctions

Five respondents (Agip, Phillips, Innogy, Statoil, Powergen) commented on the need for long-term capacity allocation arrangements. All except Innogy supported the principle of auctions, but Innogy considered that the same "outcome could be achieved through non-discriminatory, bilateral contracts thereby avoiding the need for complicated auction design and revenue treatment arrangements". Agip expressed the view "that it is essential that entry capacity should be made available for longer durations than has so far been the case. We agree that where there is demand for capacity in the future that Transco should be aware of this demand and be incentivised to respond to investment signals". Phillips stated that it supports "the aim of developing a method:

a. by which entry capacity can be bought at prices related to the cost of providing capacity,
b. that gives the industry the opportunity to signal requirements for greater capacity than that currently available, and
c. that provides companies with strong certainty of acquiring their physical capacity requirements".

Innogy, however was concerned because "the use of auctions in a price-controlled environment inevitably generates differences between actual and allowed revenue. The mechanisms to deal with the any under or over-recovery inevitably lead to unwelcome distributive effects either between classes of system user or between current and future system users. Any allocation mechanism should be designed to minimise the risk of over or under-recovery". Innogy went on to state, "that an administered approach is necessary for long-term investment planning, with any long-term allocation process informing, rather than driving this process".

Statoil observed that it "has strongly supported the establishment of a long-term NTS entry capacity allocation mechanism and welcomes TFE's initiative in developing this model. STUK also strongly believes that long-term capacity allocation should be designed to promote a liquid secondary market. A mechanism that meets these objectives will best enable market participants to plan and adjust their positions efficiently and so contribute to an effective competitive market and security of supply." Powergen stated that they would "prefer that as many tools as possible are available to bring capacity to market, such as within-day, daily interruptible, day ahead, monthly, quarterly, annually and longer."

Transco Response

Transco welcomes Users' support for the principle of long-term entry capacity allocation. Transco recognises that there is widespread concern that reliance upon a value based allocation will generate revenues that are inconsistent with a price capped utility and that subsequent redistributive mechanisms could undermine the efficiency of the allocation process and have adverse consequences for shipper to shipper competition.

11.2 Withholding of Capacity

Eight respondents commented on the issue of whether capacity should be withheld for short term allocation, of those that commented two (Powergen, Innogy) supported Ofgem's proposal that 20% be withheld until the year ahead and six (Agip, EMGM, Phillips, TFE G&P, BP, BGS) did not, although Phillips recognised "that EU competition requirements will prevail and a quantity will need to be withheld from the QSEC auction". Statoil commented that "there is uncertainty about whether the proposed withholding of 20% of initial baseline capacity from a long-term auction and how it could interact with this model".

Agip detailed a number of concerns about this issue. "Firstly, withholding any capacity will cause unnecessary constraints and have an inflationary effect on the price of long term entry capacity. Any increase in the cost of long-term capacity is likely to be passed on by shippers to the end consumer". "Secondly, withholding capacity from the auctions will have a damaging effect on the investment signals of when and where there is demand for capacity in the future. This may lead to inadequate and inefficient investment in the NTS by Transco, again leading to increased prices for capacity and causing possible issues of security of supply". "Whilst we can understand Ofgem's concerns for new entrants and possible barriers to entry, we feel that withholding capacity will actually prevent a liquid secondary market from developing. It is further Agip's belief that the UK gas market is structured in such a way that there is ample evidence of sufficient competition in nearly all aspects of the market (including the market for system entry capacity at most terminals) already in existence." "Finally, withholding capacity from the market with the intention of reviewing this situation in two years time creates unnecessary uncertainty in the market and is debatably, in and of itself, an anti-competitive practice".

Transco Response

Transco expects the minimum quantities of capacity it must make available for sale to be specified in its GT Licence. Concerns about the definition of this quantity are, therefore, a matter for Ofgem to consider in light of responses to its consultation on proposed amendments to Transco's GT Licence.

11.3 Transco's Licence

Statoil, SGD and Agip commented that there might be inconsistencies between Modification Proposal 0508 and Transco's revised GT Licence, as it has not been further developed to be compatible with Ofgem's proposed amendments. In addition the three parties and BGS expressed concern that the continuing uncertainty surrounding the Licence revisions, mean that a decision cannot be made about this proposal or Modification Proposal 0500. Statoil commented that "Ofgem's Licence proposals are highly complex and it has not yet been demonstrated whether capacity allocation mechanisms in line with Modification Proposal 0508 would be compatible and workable under these."

Transco Response

Transco agrees that there are inconsistencies between Modification Proposal 0508 and Ofgem's proposals for Transco's revised GT Licence, should this Modification and the proposed Licence amendments be implemented it may be necessary for another Modification Proposal to be raised to ensure compliance of the Network Code and with the proposed GT Licence.

11.4 Supporting Documents

A number of new documents will be required by Transco's amended Licence, including an Incremental Entry Capacity Release (IECR) statement, Procurement Guidelines (PGs) and System Management Principles (SMPs).

Seven Users (EMGM, Phillips, TFEE, Statoil, Agip, BP, BGS) commented on the need for a draft of the IECR before being able to comment fully on this proposal, EMGM stated that this "statement is a crucial element of the long-term capacity allocation process in that it enables Shippers to understand how Transco will determine whether to accept any bids for incremental capacity at a particular ASEP and, if so, how much will be accepted and over what period it will be accepted ExxonMobil wishes to reserve the right to revert to Transco with revised comments regarding Modification Proposal 0508 if, following finalisation of the IECR statement, the statement is not, in our opinion, consistent with a process that results in Transco allocating incremental capacity on an efficient basis and in a timely manner." Statoil also queried "how the IECR would fit with a model where Transco are obliged to allocate capacity requested above the baseline level". Phillips outlined their expectations for the IECR and said they "assumed that the costs for investment and the prices in each price increment will be included in this statement".

BP, Statoil and Agip also commented on the need for SMPs and PGs and that drafts have not yet been issued, Statoil pointed out they will "affect commercial assessments of the regime within which the long term capacity arrangements are operating".

Transco Response

Although not part of this Modification Proposal, Transco welcomes the comments on the proposed IECR. Transco has issued a draft IECR and views have been sought from Users. Transco anticipates that a final version could be implemented in early September, dependent on implementation of Ofgem's proposed amendments to Transco's GT Licence.

11.5 Transco's Incentives

Three respondents (Innogy, BP and Statoil) commented on the interaction between Modification Proposal 0508 and Ofgem's proposed Capacity Buy Back Incentive and Entry Investment Incentive. Innogy and BP supported the modification proposal that 100% of buy back costs be paid by Transco. Innogy commented, "the proposal provides very strong incentives on Transco to invest to provide physical assets rather than offering financial rights to capacity. The complete funding of all incremental investment in the period(s) where the incremental capacity is demanded removes a significant risk from

Transco. It also has the corollary of exposing Transco to 100% of buy-back costs, which we support."

BP said they "believe that it is essential that there are appropriate incentives to ensure that appropriate amounts of requested capacity are built, so that sufficient gas can be physically landed ensuring that supplies to UK customers are secure. BP is extremely concerned. We are not convinced that appropriate measures are proposed to provide this security." BP also expressed concern that "the recently issued GT Licence consultation proposed the IECR (incremental entry capacity release) Statement, but no details are given. This, the buyback incentive and the entry capacity incentives proposed in the Licence will be critical in determining whether incremental physical capacity will be built".

Statoil commented, "the buy back incentive proposed in the Licence drafting is incompatible with mod 508".

Transco Response

Ofgem has proposed a buy back incentive for Transco that shares costs and revenues with Users. The nature of the buy-back cost apportionment as envisaged within Modification Proposal 0508 would not be consistent with Transco's GT Licence, should Ofgem's proposals be implemented..

Transco sympathises with BP's concerns about the physical availability of capacity and the strength of Transco's incentives, but believes that a firm financial product will enable those that wish to flow gas to do so on the vast majority of occasions.

11.6 Capacity Granularity & Duration

Phillips, TFE G&P, BP and Agip commented on the proposed start date for the auctions. Phillips commented that it "would like to see a transition period of 3 years consisting of annual MSEC auctions" as it understands "that Transco needs at least a 2-year lead-time for major investment, this would relieve the concern they have regarding selling incremental capacity without the ability to build it. It would also mean the shippers were not bidding for projects at associated prices, which were unfeasible for Transco to deliver". Agip expressed concern "about incremental capacity being made available from year ahead as this does not allow Transco the required time to invest in the NTS and will lead to unnecessary and costly buy-back action. It is our belief that Transco should be allowed sufficient lead times to respond to investment signals and invest in the NTS should they choose to". BP expressed a similar view and considered the lack of a transitional process in Modification Proposal 0508 "problematic because Transco could be requested to build incremental capacity that they would physically be unable to build within the required timescales". However TFE G&P did not see this as an issue and "remain sceptical about the Transco concerns about the lead times for implementation of mod 508, and of their ability to deliver timely cost reflective responses to investment signals triggered by shippers through the iterative process".

Five respondents (EMGM, Phillips Statoil, Powergen, BP) commented on the granularity of capacity offered, all except Statoil supported quarterly capacity strips. BP observed, "quarterly capacity strips would provide seasonal signals that would not be provided by annual product, and therefore that quarterly product should be a feature of the long-term allocation process". However Statoil considered "the availability of an annual or six monthly product would better facilitate 'unbundling' and hence trading of capacity in the market place".

EMGM, BP, Phillips and Powergen commented on the duration of capacity sales. EMGM supported the proposal in Modification Proposal 0508 for offering capacity 25 years in to the future and commented that a long-term allocation should enable Users to purchase capacity at least 10 years ahead. BP stated a preference for capacity sales 15 years forward "in order to provide long-term signals and sufficient flexibility for users".

Phillips expressed a preference for a five-year time horizon based on an argument that regulatory uncertainty and Transco's investment horizon of 3 to 4 years indicated that long-term bids would not be placed by many Users and are of no benefit to Transco. Phillips also argued that "the UKCS is a mature area and the gas fields have quickly declining profiles. This creates longer-term uncertainty due to reservoir performance. Therefore while long-term auctions may provide certainty for some, it is more likely to be for those larger fields outside the UKCS. Capacity for large quantities of gas would be acquired at reserve price for long periods, leaving those with shorter profiles to indicate their requirements, but triggering more expensive capacity since incremental investment by Transco may be required by that time." Powergen agreed, "it is unlikely that downstream players will seek capacity beyond 5 years".

Transco Response

Transco welcomes support from Users for the introduction of transitional arrangements for the period before Transco is able to invest to increase capacity available. However as a shipper raised this Modification Proposal, it cannot be amended within the terms of the Modification Rules - only implemented or rejected.

Transco agrees with the majority of respondents that a quarterly product would enable Users to purchase capacity with a seasonal profile, which would provide better investment signals for Transco. It is unsure why Statoil believe an annual product would facilitate unbundling of capacity.

Transco welcomes comments from Users about the duration of the auction. However as a shipper raised this Modification, it cannot be amended within the terms of the Modification Rules, only implemented or rejected.

11.7 Allocation Methodology

Eight respondents (Powergen, EMGM, Agip, BP, Innogy, Statoil, Phillips, Shell) commented on the allocation methodology proposed in Modification 0508. Powergen, EMGM, Agip and BP supported the iterative allocation process. BP said it believed "that an iterative process is preferable to a single round methodology. Iterative processes give bidders the opportunity to revise their volume bids having viewed published bid summary data for the previous round. We believe that this will result in better signals than a single round auction process". EMGM stated that it favoured "the allocation process being iterative, allowing Shippers to adjust their bids at different entry points and across strips in response to prices emerging as the bidding process proceeds."

The same respondents also favoured a process providing access to capacity at transparent prices where all participants pay the same price. Agip observed "in supporting a modification proposal for the development of long term entry capacity auctions Agip is looking for a model that provides long term secure access to capacity at fair and transparent prices. It is our view that the current Modification 508 is the better model for meeting this requirement". EMGM expressed support for "shippers tendering their volume requirements against known prices" and "all Shippers paying the same price for the same product". "BP strongly favour a volume bid based process, which we believe will provide more cost reflective charges (and probably lower ones) to a 'pay as bid' solution that we believe is likely to be driven by sentiment and perceived constraints and will thus be more volatile and less predictable".

Phillips and BP commented on the auction timescales; BP was concerned that Modification Proposal 508's iterative multiple round process could result in auctions which are spread over many weeks (15 or more)" whereas Phillips made detailed proposals to amend and increase the time between rounds, they "propose that the first two iterations are each three weeks while shippers familiarise themselves with the process" and "that each of the first two iterations (of three weeks as proposed above) has two weeks afterwards for shippers to analyse the results. As the process progresses, the seven days should be adequate for analysis."

Statoil also commented on the close-out procedure contained within the business rules, they observed that this "is an essential issue linked to consideration of whether the allocation mechanism may be 'gameable'. STUK does not believe, however, that discussions have yet shown sufficient clarity about the effectiveness of the close-out procedure and how useful they would be in preventing potential gaming. This is of serious concern to us since market confidence is essential in order to ensure an appropriate level of participation in the form of large financial commitments in a long-term capacity auction." Statoil also believes "this will necessarily create uncertainty for participants about what they are actually bidding for and how the final allocation will be made and is an essential point of detail which should be properly clarified and discussed before any long-term auction of this kind is held."

Transco Response

Transco agrees that there may be benefits from an iterative auction process, and has amended its proposals in respect of Modification Proposal 0500 to incorporate similar processes.

Transco shares BP's concerns with the length of time the auction could take to closeout, especially in the light of the proposal applying from October 2002.

Transco supports the development of a process whereby prices are transparent and where Users bid for a volume of capacity at a known price especially where the amount of capacity available is flexible. Transco shares Statoil's concerns about the close-out procedure and consequently believes that Modification Proposal 0500 would provide a better allocation mechanism.

11.8 Investment Funding

EMGM, Innogy, Statoil, Phillips, Shell and BP commented on the determination of the price to be paid by shippers; they did not support the proposed methodology. Innogy said, “any investments should be depreciated over a number of years, rather than fully paid for over a comparatively short time scale. This aspect of the proposal not only conflicts with the principles of economic regulation of monopoly network operators but potentially creates severe pricing distortions year on year. There are also aspects of this funding arrangement that are not clear, including the treatment of incremental capacity once it has been fully paid for and the distinction between capacity in the asset base and fully paid incremental”. Statoil had “reservations on the ‘full cost recovery’ aspect of the model for a variety of reasons. We believe that the model will allow significant price swings from quarter to quarter and also allow some anomalies to arise, not least that long term capacity could be zero priced after the cost has been shared among participants within the quarters where additional demand is signalled. We would question how this fits with Ofgem’s model of 45 year straight line depreciation”. Phillips expressed concern “about the aggregation of cost of incremental capacity investment; there is cross-subsidisation since users who have not signalled this requirement would be paying for part of the investment. In addition we believe that the cost of further investment should not be fully underwritten by shippers for the duration of the requirement, but discounted over the life of the asset”. Shell was also uneasy, as “this proposal would lead to some shippers funding additional capacity that they have not demanded. This could arise as all investment above baseline is equally funded at all the locations at which additional capacity has been demanded. Shippers at different terminal could be required to share bundled additional costs at different terminals. Shippers could also end up funding capacity in years for which they have not demanded capacity. We are also concerned that the process can lead to zero prices which would be open to market abuse. These effects would undermine competition between shippers and cannot be considered to be efficient nor economic.”

Transco Response

Transco does not believe that this aspect of Modification Proposal 0508 is consistent with Ofgem's proposed amendments to its GT Licence.

11.9 Credit Arrangements

Three respondents (Phillips, EMGM, Statoil) commented on the proposed credit arrangements. Phillips observed “it is not clear from the business rules that the credit arrangements provide sufficient protection to the shipper community if one party quickly lost its creditworthiness. While it is recognised that much research into credit arrangements has been carried out, there should be a mechanism to review and update the credit rating of each shipper more frequently than once a year. The credit limit should be updated against this rating. The larger the quantity of capacity and/or the longer out the capacity is held, the more frequent the creditworthiness check is required. The maximum frequency should be quarterly.”

Statoil noted "that Ofgem has recently held a consultation on future credit arrangements that may result in changes to current arrangements. Any changes to existing credit rules would be a material factor in considering which of the proposals under consultation might work best – to facilitate market participation in the auction. Furthermore, current uncertainty about future credit arrangements would in any case create difficulties for companies if a long-term auction were held without knowing the outcome of the credit debate."

EMGM stated its belief "that credit arrangements should be in place to ensure that Shippers are not exposed to the costs of another Shipper defaulting on financial commitments associated with long-term capacity. These arrangements should reflect the credit rating of the Shipper, or its parent company where appropriate, and should involve cash (held in reserve account by Transco) or Letters of Credit. A Parent Company Guarantee or other form of guarantee should only be retained where the Approved Credit Rating of the Shipper, or its parent company, is above the typical level of banks providing Letters of Credit for the same sector".

Transco Response

Transco agrees that credit arrangements can have a significant impact on the outcome of any long term auction process. Transco has tried to strike a balance between credit arrangements that create prohibitive cost for some who may otherwise wish to take part in LTSEC auctions, and weak arrangements that enable any costs of failure to be passed on to other Users. Transco believes that a 12-month capacity credit requirement is the maximum term of credit guarantee that can be obtained without recourse to bespoke (therefore expensive) products. Transco believes that the principles associated with the processes defined in Modification Proposal 0509 would apply, whereby if a User is terminated their capacity would be released for sale in subsequent auctions to other parties (except where it has been traded to another User). In addition, Ofgem has proposed a Licence condition that would require Transco to offer any recalled capacity for sale in subsequent auctions.

Transco has considered parent company guarantees and discussed this in Workstream meetings. The value of such guarantees can change dramatically as recent history has demonstrated. Transco sympathises with the view expressed by respondents in respect of the form and nature of credit. However, it is mindful that any approach must be not unduly discriminatory.

11.10 Process & Implementation Issues

Shell and TXU were surprised that Modification 0508 was still out for consultation; TXU understood "after discussions between TFE and Transco and further industry debate, that elements of this modification proposal have been incorporated into the revised Modification 500. In addition, that subject to the mode of implementation of Mod 500 meeting a number of their concerns, that TFE would consider possible withdrawal in respect of mod 508". However TFEE considered that "despite the detailed discussions with Transco there remain some elements of the current version of modification 500 that TFE are not able to support, as they are inconsistent with the principles proposed in modification 508".

Seven Users (Powergen, Phillips, Agip, Statoil, EMGM, BP, BGS) were concerned the implementation of long term auctions was being rushed and should be delayed until Transco's Licence has been finalised. Agip was "apprehensive about the implementation of long term entry capacity auctions at this time. Agip are keen for long term entry capacity auctions to be implemented as soon as possible but would prefer to see a robust, well tested and understood process implemented at a later time than one that has been rushed and is not fully developed. We would prefer to see the development of long term entry capacity auctions delayed until the Licence modifications have been finalised and the IECR statement, System Management Principles and Procurement Guidelines published." BP supported this approach and suggested a similar process. EMGM observed, the implementation of a process to allocate long-term entry capacity is an extremely important stage in the development of the NTS capacity regime. In our view, it would be inappropriate to implement a long-term capacity allocation process unless there was a high degree of confidence within the industry that the process was enduring and robust. We are not convinced that such confidence exists across the industry at this time". BGS "believes it is essential that whatever allocation methodology is put in place, that every effort is made to 'get it right first time'. This cannot be done if the process is unduly rushed, and the consequences of mistakes made now will likely be felt for many years to come".

Phillips however needed "sufficient focused time to prepare a bid strategy and obtain management approval for the August auctions. This work would ideally be done during June and July and it is unlikely that the decisions from Ofgem and preparatory information from Transco will be available. The industry would also be preoccupied with the MSEC auctions during July" and proposed that in the first instance the capacity for October 2004 onwards can be auctioned in any month during the 4th quarter of 2002 or even 1st quarter of 2003, to provide the whole industry with the necessary preparation time".

Transco Response

Transco sympathises with respondents view that there has been uncertainty concerning regime changes for entry capacity, including Ofgem's proposed changes to Transco's GT Licence. Transco has indicated that it would not be able to develop systems to implement Modification 0508 before February 2003, which would result in additional preparation time being available.

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 - September 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.

17. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This Modification Report contains Transco's proposal not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

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

19. Text

Transco does not support implementation of this Modification Proposal, therefore no legal text is provided.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date:

<u>Gas and Electricity Markets Authority Response:</u>

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0508**, version **1.0** dated **19/08/2002**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

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

Signature:

Process Manager - Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:

   (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or

   (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

   provided that if the Authority does not so approve the Agreement then Clause 3 shall apply.

2. If the Authority does so approve this Agreement in accordance with the terms of the Order <u>(whether such approval is actual or deemed by effluxion of time)</u> any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.

3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, <u>had it not been repealed, would</u> apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) <u>or 2(2)(b)(ii)</u> of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.

4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.