

Modification Report
Recovery of Financing Costs for Operating Margins Gas
Modification Reference Number 0523
Version 1.0

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

It is proposed to amend the Network Code so that Transco may recover the financing costs it incurs in making quantities of gas available for Operating Margins (OM) purposes.

It is proposed that for each day Transco would be entitled to recover an amount equal to:

(Net Margins Weighted Average Cost of gas-in-storage) * (Neutrality Interest Rate)

where:

- a. Net Margins Weighted Average Cost of Gas includes the costs associated with the procurement of OM gas (excluding Storage Space charges) as defined by Section K4.2.6 of the Network Code;
- b. Neutrality Interest Rate means: the percentage rate calculated as the base rate for the time being of Barclays Bank plc divided by 365.

It is proposed that the OM financing costs would be included in the calculation of the Daily Margins Recovery Amount which is included within the balancing neutrality provisions of the Network Code.

2. Transco's Opinion

Section K of the Network Code requires Transco to procure Storage Space and fill that space with sufficient quantities of gas to satisfy OM requirements in relation to a Storage Year. In doing so, Transco incurs financing costs for which it is not compensated.

Transco receives an operating expenditure (opex) allowance within its price control to fund the procurement of Storage Space for OM purposes. However, under existing Network Code arrangements Transco only recovers the cost of OM gas and other associated costs when and to the extent that OM gas is used. Financing costs are excluded from this process and as a result Transco receives no funding for the costs of financing an investment of approximately £9m in OM gas.

Transco believes that a precedent has already been set for the recovery of OM financing costs. Previously, Section K5.4, version 2.00 (31 May 1998) of the Network Code

allowed Transco to recover the financing costs it incurred in making sufficient quantities of Balancing Margins gas available in each Storage Year. Transco believes that its obligations in relation to the use and procurement of gas for Balancing Margins purposes were akin to its existing obligations in relation to OM. Therefore, Transco believes that it should recover the financing costs it incurs in the provision of OM gas.

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

Transco believes that this Modification Proposal would be consistent with Section 4AA(2)(b) of the Gas Act 1986 (as amended by the Utilities Act 2000) which requires that Transco is allowed sufficient funding to finance its activities in operating the gas transmission system.

Consequently, Transco believes that this Modification Proposal is consistent with Special Condition 3(1) of Transco's GT Licence, i.e. that Transco should secure sufficient financial facilities to enable it to carry on the transportation business. Consistency with Special Condition 3(1) satisfies Transco's relevant objectives as defined by Standard Condition 9(1)(b) of Transco's GT Licence which requires the efficient discharge of Transco's obligations under the GT Licence.

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

a) implications for the operation of the System:

Transco is not aware of any implications for the operation of the System.

b) development and capital cost and operating cost implications:

Transco is not aware of any development, capital or operating costs which would arise from the implementation of this Modification Proposal.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

Not applicable.

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

Transco is not aware of any consequences that this proposal would have on price regulation.

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

This Modification Proposal would not affect Transco's contractual risk under the Network Code.

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

Transco is not aware of any implications for computer systems of Transco and related computer systems of Users.

7. The implications of implementing the Modification Proposal for Users

Users would be required to reimburse Transco in relation to the financing costs it incurs in providing OM gas. The exact cost to Users would be dependent upon the volume and price of gas stored by Transco for OM purposes. However, Transco believes that the financing costs that it seeks to recover would be in the range of £750k to £1m per annum. The OM financing costs would be apportioned between Shippers using Balancing Neutrality Charges as defined in Section F4 of the Network Code.

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

Transco is not aware of any implications for Terminal Operators, Consumers, Connected System Operators, Storage Operators, suppliers, producers or any non-Network Code party.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

Transco is unaware of any affect on the legislative and regulatory obligations and contractual relationships of Transco and each User and non-Network Code party of implementing the Modification Proposal.

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

Transco believes that the advantages of implementing this Modification Proposal are:

- Compliance with Section 4AA(2)(b) Gas Act 1986 (as amended by the Utilities Act 2000) which requires that Transco is allowed sufficient funding to finance its activities in operating the gas transmission system.

- Adherence to Special Condition 3(1) of Transco's GT Licence, i.e. that Transco should secure sufficient financial facilities to enable it to carry on the transportation business.
- Consistency with Standard Condition 9 of Transco's GT Licence which requires the efficient discharge of Transco's obligations under the GT Licence.

If this Modification Proposal is implemented Users' operating costs would increase and this may be perceived as being a disadvantage. However, Transco believes that the impact on Users would not be significant. The OM financing costs are not substantial and the cost would be shared between all Users.

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

Transco received representations in respect of this Modification Proposal from two Users, namely: Scottish and Southern Energy (SSE) and British Gas Trading (BGT).

Transco welcomes SSE's support for the principle that Transco should be able to recover the financing costs associated with the procurement and storage of Operating Margins gas. Whilst supporting the proposal in principle SSE raised the following concerns:

- Given that Ofgem's final proposals for Transco's NTS SO incentives relate to the cost of OM gas, it is difficult to assess the impact of this proposal prior to the drafting for Transco's GT Licence being finalised.
- It is not clear how Transco will recover these costs in the longer term given Ofgem's desire to see balancing neutrality costs incorporated into the SO Commodity Charge.
- Transco is already subject to an economic purchase obligation when procuring OM gas and it is assumed that this would be extended to include the financing cost that Transco is looking to recover from Users.

Transco recognises there is a degree of uncertainty regarding the final drafting for Transco's GT Licence. However, Transco does not believe that this uncertainty impacts upon this Modification Proposal. Transco's proposals for NTS SO Transportation Charges were set out in Pricing Consultation (PC)70. Inter alia, Transco proposed the continuation of neutrality mechanisms for OM gas. In a letter dated 6 February 2002 Ofgem confirmed to Transco and Shippers that Ofgem has decided "... not to propose licence modifications that would have the effect of discontinuing the existing capacity (and energy) neutrality arrangements for the six month period commencing 1 April 2002."

The Network Code specifies the methods that Transco must use in procuring OM gas (Section K3.5). Transco does not believe that this equates to an economic purchase obligation, and Transco does not believe that it is appropriate for there to be an economic purchase obligation in relation to the financing costs incurred in procuring OM gas. Transco is seeking to recover financing costs in a manner that is consistent with existing Network Code arrangements, i.e. through the daily application of the Neutrality Interest Rate to the value of the OM gas in storage. The Neutrality Interest Rate is defined by the Network Code as being "the percentage rate calculated as the base rate for the time being of Barclays Bank plc divided by 365.". Therefore, the financing costs that Transco seeks to recover will be determined by a market rate and Transco believes that this limiting factor is sufficient to prevent the recovery of an uneconomic level of financing costs.

BGT stated that it does not support this proposal and expressed the following views:

- There is a Network Code requirement upon Transco to provide OM gas and the funding of this arrangement has been established.
- To separately identify financing costs is an attempt to reduce Transco's exposure to its OM obligations and this would act as a disincentive to keep costs to a minimum.
- As Transco now has an increased role as a trading body, this should facilitate the acquisition and disposal of OM gas in parallel to their other activities, which could avoid their being viewed in the position of a disadvantaged buyer/seller.

Transco acknowledges that the Network Code places a requirement upon it to provide OM gas. For reasons stated in this Modification Report Transco believes that amendment of the established funding mechanism in respect of these obligations will better facilitate the relevant objectives.

Ofgem's final proposals for Transco's NTS SO incentives 2002-2007 place strong incentives on Transco to minimise OM Storage Space costs and consequently OM gas costs. Ofgem has proposed that in respect of OM Storage Space costs, Transco will be subject to 100% upside and 100% downside sharing factors for deviations from annual target costs with no cap or collar. Transco does not believe that this strong incentive to reduce costs would be impeded by this Modification Proposal.

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

With the exception of the legislation referred to above, Transco does not believe that implementation of this Modification Proposal is required to facilitate compliance with safety or other legislation.

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

Transco does not believe that this Modification Proposal is required in respect of any proposed change in the methodology established under Standard Condition 4(5) of the statement; furnished by Transco under Standard Condition 4(1) of the Licence.

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

Transco is not aware of any programme of works that would be required as a consequence of implementing the Modification Proposal.

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

It is proposed that Transco would recover OM financing costs from Users as of 1 April 2002. Transco is not aware of any systems changes that would be required as a result of this Modification Proposal.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that this Modification Proposal is implemented with effect from 1 April 2002.

17. Restrictive Trade Practices Act

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

18. Transco's Proposal

This Modification Report contains Transco's proposal to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

SECTION K: OPERATING MARGINS

Change heading to paragraph 4.3 to read 'Daily Margins Recovery Amount and Financing Costs'.

Amend paragraph 4.3.2 to read as follows:

"

- (i)Net Margins WACOG;
- (ii)in respect of the Day; and
- (iii) the amount of the Margins Gas Financing Cost for the Day in accordance with paragraph 4.3.5."

Add new paragraph 4.3.5 to read as follows:

"4.3.5 **"Margins Gas Financing Cost"** in respect of a Day is the amount calculated as the sum, for all Storage Facilities, of the aggregate amount of gas-in-storage held by Transco (Margins) on that Day for Operating Margins Purposes, multiplied by the Net Margins WACOG, multiplied by the Neutrality Interest Rate for the Day."

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date:

Gas and Electricity Markets Authority Response:

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 **0523**, version **1.0** dated **19/02/2002**) 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 appropriateprovided 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 (whether such approval is actual or deemed by effluxion of time) 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, had it not been repealed, would 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) or 2(2)(b)(ii) 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.