

Modification Report
Treatment of Constrained Top-up Costs for Storage Year 2002/03.
Modification Reference Number 0529
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

Transco proposes continuation of the Constrained Top-up cost recovery arrangements implemented through Modification Proposals 0391 and 0451 for one further year, commencing 1st May 2002.

2. Transco's Opinion

Transco believes that its GT Licence obligation to meet peak transportation requirements should be funded appropriately. These requirements are met in part through the use of Constrained LNG (CLNG). To the extent that shippers do not book sufficient CLNG Services, Transco does so as Top-up Manager, to meet its Licence and Network Code obligations, and therefore should be funded. Top-up Neutrality is an established and appropriate method of funding. Transco supports extending the present cost recovery arrangements for a further period of one year.

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

Under the terms of the GT Licence (Standard Condition 16 (2)), Transco's pipeline system must meet the aggregate daily demand which is likely to be exceeded only in 1 year out of 20 years. In certain geographical areas a combination of physical pipeline capacity and CLNG is more economic and efficient than providing physical pipeline capacity alone. If this Modification Proposal is not implemented, Transco would be required to fund any shortfall in CLNG bookings, whereas the alternative of pipeline investment could be included in the Regulatory Asset Base and earn an appropriate return. This could be regarded as a perverse incentive on Transco to invest in new pipeline capacity rather than utilise existing LNG assets. Such investments might conflict with Standard Condition 9 (a): the efficient and economic operation by the Licensee of its pipeline system. Therefore implementation of this Modification Proposal would better facilitate this relevant objective.

**4. The implications for Transco of implementing the Modification Proposal , including
a) implications for the operation of the System:**

As implementation of this Modification Proposal would continue the present arrangements, there would be no implication for the operation of the System.

b) development and capital cost and operating cost implications:

There are no development or capital cost implications. If this Modification Proposal were implemented, Transco would still be responsible for financing the initial purchase of storage services and gas. However, it would recover these costs within a year through Top-up Neutrality charges levied in respect of the December to March (inclusive) winter period.

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:

Recovery of Constrained Top-up costs as contemplated by this Modification Proposal is appropriate, for the reason given under "Transco's opinion" above.

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

Implementation of this Modification Proposal would have no effect 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

Implementation of this Modification Proposal would reduce the level of contractual risk faced by Transco under the Network Code for Storage Year 2002/03, because it would remove the exposure to Constrained Top-up costs. These costs would arise to the extent that Users did not book and fill sufficient CLNG to meet Transco's transmission support requirements.

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

Transco is unaware of any development or other implications for the computer systems of Transco or for the related systems of Users.

7. The implications of implementing the Modification Proposal for Users

Users, as opposed to Transco, would bear any Constrained Top-up costs arising in Storage Year 2002/3. Any such costs would be shared in proportion to firm UDQO's over the winter period of December 2002 to March 2003 inclusive, in accordance with the established Top-up Neutrality apportionment methodology.

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

It may be expected that Users would wish to pass on any additional costs to suppliers and consumers.

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

Implementation of this Modification Proposal would maintain the financing of Transco's licence obligations to provide transportation capacity sufficient for 1-20 peak demands.

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

Advantages:

- Allow Transco to recover costs not provided for under the price control;
- Avoid undue contractual risk to Transco;
- Avoid inappropriate investment signals and so discourage potentially uneconomic and inefficient investment in pipelines.

Disadvantage:

- Increase Users' exposure to Top-up neutrality charges.

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

Two representations were received from BGT and Shell Gas Direct (SGD), neither of which supported implementation of this Modification Proposal.

BGT's objections largely reiterated those submitted for Modification Proposals 0356, 0391 and 0451, namely;

- reference made to earlier Ofgas documents, in particular Ofgas' 1998 Review of Top-up, in which Ofgas said that Transco should bear the costs of constraints/Top-up bookings;
- the proposal provides Transco with no incentive to optimise Top-up costs or capital expenditure;
- Transco continues to propose an unfocussed cost recovery; does not target those shippers which fail to make adequate peak gas day provision and do not contribute to local transmission needs by booking CLNG.

Additionally, BGT drew attention to the National Transmission System (NTS) System Operation Incentives 2002-7, which will enable Transco to substitute pipeline investment for less expensive alternatives eg interruption, storage use, in order to meet the demand at NTS exit points. This will promote further long-term security of supply to the benefit of customers. BGT believes that the isolation of Transco from the costs of Constrained Top-up would dilute and hamper the effectiveness of promoting long-term security of supply. SGD confirmed its agreement with Ofgas' view that Transco should bear the full costs of transportation constraints stating that "To do otherwise removes any incentive from Transco to optimise between expenditure on Top-up and making capital investment".

BGT referred to Transco's opinion that a "perverse incentive" could be created to invest in new pipeline capacity, which would attract a regulatory asset value, as opposed to utilising existing LNG assets. BGT argued that if Transco were to be isolated from CLNG costs, this would create a perverse incentive and be likely to cause a "poor decision to be made". BGT recommended that each option for meeting NTS exit demand should be considered on an economic basis. SGD did not agree with Transco's view that the incentive would be "perverse" stating that the effect of this Modification Proposal "would appear to be contrary to the principles of Ofgem's proposals for Transco's SO incentives which aim to give Transco incentives to make such decisions".

BGT expressed disappointment that Transco "continue to do little to promote consideration of some form of cost-sharing between Transco and shippers"... "or consider whether any component of costs assigned to shippers could be better focussed". Whilst understanding the reasons for lack of progression of the Review, SGD confirmed its disappointment that Transco had not identified alternative proposals for the treatment of these costs, citing that "Those respondents who did support Modification 0451 did so on the basis that a review would take place in the interim".

BGT noted that "if the LNG auction and the transmission benefit arrangements remain substantially as in 2001/02 there might well be no requirement for Constrained Top-Up again in 2002/3, in which case this Modification would have no practical impact".

BGT concluded that it was vital that the industry be aware of transmission benefit arrangements for 2002/03 before the close of the LNG Auctions (9 April).

Transco's opinion

Transco has considered a number of alternative methods which would effectively result in a levy on charges for all Users, but to date neither Transco, nor any User, has identified a method of apportionment that better facilitates the relevant objectives. Transco believes that requests for a methodology to better focus the costs on those shippers who fail to make adequate peak gas day provision oversimplifies the benefit of constrained Top-up. The provision of transportation capacity by constrained Top-up not only benefits consumers downstream of the constrained facility, but also frees up capacity upstream thereby conferring a benefit to a wide group of Users.

Whilst acknowledging views on cost apportionment, Transco confirms its willingness to consider any alternatives to the present methodology which Users wish to raise. In the absence of any such alternative, it suggests that the existing methodology should continue particularly as the Modification Proposal considers an extension of existing arrangements for a further twelve months. Transco believes it is therefore appropriate for the apportionment of costs to be based upon each Users firm UDQOs on each day of the winter period when this service has a direct benefit.

Transco believes that issues of equivalence of system exit points and storage entry points should be explored in the context of a wider exit review. However, Transco believes that it

would be inappropriate to attempt to develop this issue in isolation of other aspects of such an exit review. This is consistent with this Modification Proposal in that Transco is seeking to extend current arrangements for a further twelve months.

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

Implementation of this Modification Proposal is not 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

Implementation of this Modification Proposal would not change the methodology established under Standard Condition (4) 1 or (4) 5 of the Licence.

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

Transco would continue to be required to additionally calculate and invoice any Top-up Neutrality charges applicable to the winter period, consistent with established methodology and using existing systems.

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

Transco proposes that this Modification Proposal should be implemented with effect from 1 May 2002.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends this Modification Proposal should be implemented.

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

TRANSITION DOCUMENT, PART II

Amend paragraph 8.12 to read as follows:

"Section P: Top-up Storage

*(1) Paragraphs (2) to (6) shall apply in respect of the Storage Years commencing 1 May, 2000, 1 May 2001 and 1 May 2002 ("**relevant**" Storage Years).*

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 **0529**, version **1.0** dated **22/03/2002**) 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.