

**Modification Report**  
**Limitation of incremental capacity offered in QSEC auctions**  
**Modification Reference Number 0036**  
Version 3.0

This Modification Report is made pursuant to Rule 10 of the Modification Rules and follows the format required under Rule 9.6.

**Circumstances Making this Modification Proposal Urgent:**

In accordance with Rule 10.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because if this proposal and Modification Proposal 0037: 'Limitation on offering for sale unsold capacity' were to follow non-urgent procedures, Ofgem would be “unlikely to be in a position to make a decision regarding the acceptance or otherwise of these proposals ahead of the QSEC auctions invitation being issued. This may remove the opportunity for Transco NTS, and therefore shippers and consumers, to avoid what may otherwise be avoidable costs.”

**Procedures Followed:**

The procedures agreed with Ofgem for this Proposal are:

Proposal sent to Ofgem requesting Urgency	13/07/2005
Ofgem grant Urgent status	15/07/2005
Proposal issued for consultation (5 working days)	18/07/2005
Close out of representations	25/07/2005
Urgent Modification Report issued (5 working days)	01/08/2005
Modification Panel decide upon recommendation	08/08/2005
Revised Urgent Modification Report issued to Ofgem	09/08/2005
Ofgem decision expected	15/08/2005

**1. The Modification Proposal**

The Proposal submitted was as follows:

"Transco NTS is obliged to offer for sale in a QSEC auction incremental capacity with the maximum amount not being less than 150% of the NTS SO Baseline Entry Capacity. This could, however, be inconsistent with the requirements of Transco NTS's Incremental Entry Capacity Release (IECR) Methodology Statement, which it prepares in accordance with Special Standard Condition C18 of its Transporter's Licence. It is therefore proposed that it be clarified within the UNC that incremental amounts should be consistent with any relevant provisions of the IECR statement.

Indeed, Transco NTS has proposed, and Ofgem has approved, that the IECR be amended to allow Transco NTS some flexibility pre-auction to not release incremental capacity to Users when certain criteria are met; specifically when Transco NTS assesses prior to a capacity release that it may be unable to physically deliver all or part of the incremental

capacity within a three-year lead time. Under these circumstances, the total level of buy-back costs at the affected ASEP is likely to be higher, than would otherwise be the case, if the incremental capacity is offered for sale and would be above that considered to be efficient and economic. While Transco NTS would be partly exposed to the buy-back costs in accordance with the incentive arrangements in its Transporter's Licence, the capacity neutrality arrangements would result in all Users funding a significant proportion of these costs, which could ultimately be passed on to consumers.

In the event that the IECR criteria are met, Transco NTS would specify a revised lead-time to be applied to all or part of the capacity to be released at the affected ASEP in the QSEC auction invitation, otherwise the default minimum of 150% of the NTS SO Baseline would apply for each relevant capacity year in the QSEC auction.

Transco NTS believes this Proposal must be implemented prior to issuing invitations for the next QSEC auction, which, in accordance with the provisions of TPD Section B2.2, must state the amount of capacity that is available for each relevant capacity year. However, if this Proposal were not implemented in the timescales identified, Transco NTS believes it and other Users could be exposed to inefficient levels of buy-back costs."

## **2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives**

In this Proposal Transco NTS (the Proposer) stated:

'Transco NTS considers this Proposal would, if implemented, better facilitate the following Relevant Objective as set out in its Gas Transporters Licence:

in respect of Standard Special Condition A11 paragraph 1(a), the Proposal would better facilitate the economic and efficient operation of the NTS pipeline system by not releasing incremental capacity that is likely to result in buy-back costs being incurred by both Transco NTS and Users above that which would be considered to be economic and efficient.'

E.ON stated in response to this Proposal (and also 0037) *'Neither proposal is clear in the discretion which Transco can use to hold back incremental entry capacity as the result of being unable to make the three year lead time, undermining the current balance between revenue received from incremental outputs, weighed against the risk of buy-back to ensure against inefficient investment in the system. Both proposals therefore destabilise the relevant objective (a) the efficient and economic investment in the system, through providing a means by which Transco can circumvent its incentives'*

## **3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation**

In this Proposal the Proposer stated: 'Transco NTS does not believe this Proposal, if implemented, would adversely impact upon security of supply, operation of the Total System, or industry fragmentation.'

No comments were received on this aspect within the representations.

**4. The implications for Transporters and each Transporter of implementing the Modification Proposal , including**

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

In this Proposal, the Proposer stated: ‘Transco NTS does not believe this Proposal, if implemented, would adversely affect the operation of the System.’

No comments were received on this aspect within the representations.

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

In this Proposal, the Proposer stated: ‘Transco NTS considers that this Proposal would reduce the potential increase in buy backs costs it may incur above that which would be considered to be economic and efficient. However, if Transco NTS did not release incremental capacity, it may limit its opportunity to earn entry capacity investment incentive revenue under Special Condition C8B Part 2 paragraph 14(5) of its Transporters Licence.’

No comments were received on this aspect within the representations.

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

In this Proposal, the Proposer stated: ‘Transco NTS does not believe this Proposal, if implemented, requires it to recover any additional costs.’

No comments were received on this aspect within the representations.

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

In this Proposal, the Proposer stated: ‘Transco NTS does not believe this Proposal, if implemented, would have any consequences on price regulation.’

No comments were received on this aspect within the representations.

**5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal**

In this Proposal, the Proposer stated: ‘Transco NTS believes that the Proposal reduces the contractual risk that it is exposed to by reducing the volume of capacity that it is required to offer for sale in limited circumstances.’ No comments were received on this aspect within the representations.

**6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users**

In this Proposal, the Proposer stated: ‘Transco NTS does not envisage any impact on the UK Link System if this Proposal were to be implemented.’

No comments were received on this aspect within the representations.

**7. The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk**

In this Proposal, the Proposer stated: ‘Transco NTS considers that this Proposal would reduce the potential increase in buy backs costs incurred by Users above that which would be considered to be economic and efficient.’

No comments were received on this aspect within the representations.

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

No comments were received on this aspect within the representations.

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

No comments were received on this aspect within the representations.

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

**Advantages of the Proposal**

In this Proposal the Proposer stated: ‘Transco NTS believes that this Proposal, if implemented, would ensure consistency in the determination of incremental capacity amounts between UNC and the IECR Methodology Statement. This would therefore prevent the release of incremental capacity via the QSEC auction invitation that Transco NTS is likely to be unable to physically deliver within the typical 3 year investment lead time and avoid the generation of buy-back costs above that considered to be efficient and economic.’

**Disadvantages of the Proposal**

In this Proposal the Proposer stated: ‘Transco NTS recognises that this Proposal may limit the amount of incremental capacity released in the QSEC auctions. However, Transco NTS believes that this is necessary where this is in accordance with specific circumstances set out in the IECR Methodology Statement.’

Reference is made to E.ON's comments as summarised in section 2 above.

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

Representations were received from nine respondents, of which two were marked confidential. The seven non-confidential respondents are listed below.

British Gas Trading	(BGT)	Not in support
E.ON UK	(E.ON)	Not in support
RWE npower	(RWE)	Qualified support
Scottish and Southern Energy plc	(SSE)	Not in support
Statoil UK	(STUK)	Not in support
Total Gas and Power (TGP) and Total E&P UK plc	(TGP)	Qualified support
Transco NTS		In support

The Proposer was in support of this Proposal. There were two responses that offered qualified support and six (including two confidential) that were not in support.

The main issues raised in the representations have been grouped into four sections as below:

### 11.1 Timing of consultation and Response to IECR consultation

RWE offered qualified support for the proposal stating that they would prefer not to amend the IECR methodology statement parameters during the current price control period. RWE stated *‘However, given that a change has been made, we support the principle of pre-auction certainty rather than allowing Transco NTS flexibility after the auctions and agree that this modification proposal aligns the UNC with the IECR statement’*

TGP also offered qualified support because of the process that has been followed in raising the proposal. *‘Our preference would have been for this topic to have been fully discussed in the normal industry workstream and, on the assumption that it would have been accepted by the industry, to amend the IECR in line with the amendments to the UNC.’*

*Unfortunately, Transco NTS have sought to do this the other way round by agreeing the changes to the IECR with Ofgem first, thus ensuring that Users had no effective input into the process and only then raising the proposal on the grounds of bringing the code into line with the IECR. This has also resulted in an Urgent modification having to be raised when in practice it is difficult to believe that Transco NTS have not known about this issue for some considerable period of time.’* TGP also stated *‘In our response to the IECR consultation paper we stated that we believed that any assessment as to the timeliness of when physical capacity could be delivered, should be done ahead of, rather than post, auction.’*

BGT expressed concern at the manner in which the proposal has been raised and the fact that not all related issues have been addressed. *‘The raising of Urgent proposals with only 5 days to allow Users to respond to proposals, which will have far reaching effects on the LTSEC process by which Users procure requirements for system entry capacity well into the future, is unacceptable.’* BGT commented that the amendment of one document does not imply urgency can be applied to other related documents. *This approach exemplifies*

*an abuse of process where a piecemeal approach to implementation of change has been adopted. We have long advocated the engagement of industry parties in full and open consideration of such issues prior to proposing amendment of all related documentation in a consistent and co-ordinated manner.'*

E.ON stated that concerns were expressed in connection with changes proposed to investment lead times as part of the IECR consultation process and have not had the opportunity to see the consultation response (see note below). SSE stated *'It is disappointing that we have been unable to see the report on the consultation (to which we responded) and that there seems to be no Ofgem letter to accompany its decision not to veto the amendments. We therefore have no indication of Transco NTS's views on the points we raised in our response which might have helped inform our opinion on this proposal.'* STUK stated *'The primary justification for this modification appears to be to ensure that the UNC is in line with the IECR yet it is not clear what opinion was given under that consultation process which prompted the changes in the IECR or whether any reasons were given on why Ofgem did not veto the changes.'* STUK also stated *'It is also not clear that the IECR should be driving changes in the UNC, both are required through the Transco NTS license and interact with each other but STUK would assume that the UNC be the appropriate method through which change is driven as it is the most open and transparent of the two.'*

Note: The Transco NTS document "IECR Review 2005 – Report on Consultation Responses" was circulated on 26th July 2005, after the close out date for representations

## **11.2 Incentives**

Four respondents (BGT, E.ON, RWE, SSE) commented on the issue of incentives.

BGT stated *'The modification proposals cite the commercial exposure directly to the Transporter and indirectly to the wider industry through neutrality. As the exposure to this element of risk is largely within the control of the Transporter, we believe that this issue of incentives also needs to be considered in this context. The effect of these Modifications would be to reduce the risks associated with the inability to deliver obligated capacity, therefore the degree of exposure to incentives should reflect this change by increasing their share of the related buybacks. This is a further reason for a more holistic approach to modifications of this nature.'*

E.ON stated *'Incentives and revenues are set relating to the required baseline and incremental outputs and any proposal which impacts these must be dealt with through the proper mechanisms of a price control review and not through a Code modification, to ensure the full impact of the proposals is understood and appropriately assessed.'*

RWE commented that if Transco NTS failed to deliver capacity against an extended time frame then it should face additional liabilities and stated *'the main argument for introducing this flexibility is for shippers and Transco NTS to avoid potentially high buy-back costs. We have consistently argued that for Transco NTS to make the efficient decision between investment and buy-back, it alone should be exposed to buy-back costs.'*

SSE stated *'In its response to the recent IECR methodology statement consultation, SSE explained its view that the changes were not appropriate because the whole licence and incentive regime framework for the NTS entry capacity regime is predicated on the fact*

*that Transco argued that a three year lead time was required for it to invest in physical assets.’ and ‘As the capacity release takes place after the auctions, Transco NTS’s incentive is designed to encourage it to assess whether or not to release the capacity. Such assessment is based on the balance of the reward of building a physical asset vs the buy back risk.’*

*STUK commented ‘Furthermore STUK believe that Transco NTS should manage its exposure to buybacks through the various tools currently at its disposal, i.e. buying back on a forwards basis or through options. The changes as set out will give Transco NTS the option to avoid such costs by building is extended lead times on capacity projects.’*

### **11.3 Circumstances when relaxation of 3-year rule would apply**

Two respondents (BGT, E.ON) commented that more clarity was required as to when more than three years may be necessary in order to provide the full 150% of baseline capacity.

*BGT stated ‘In the lengthy process that implemented arrangements for the allocation of Long Term System Entry Capacity (Modification Proposal 500), there were a number of high level principles instilled in the details. One of these was the availability of incremental capacity up to 150% of baseline within three years where a clear signal had been indicated through the allocation process. We are strongly of the view that this principle remains paramount. However, we recognise that there may be exceptional circumstances where it is not possible, for reasons outside the control of the Transporter, to meet this requirement. In such exceptional circumstances it may be appropriate to allow minimal departure from this principal. Where this is the case the reasons for the variation must be open and transparent and variation sanctioned by the regulator. Any resulting restriction in the availability of incremental capacity must be visible to participants in the LTSEC process in advance of it being conducted.’*

*E.ON stated in its response to both Mod 0036 and Mod 0037 ‘Both proposals allow for Transco to deviate away from the three year investment lead time, which, as we noted in our response to the changes proposed in the IECR Methodology Statement, raises some serious questions of what has changed to make this no longer tenable. Neither proposal is clear in the discretion which Transco can use to hold back incremental entry capacity as the result of being unable to make the three year lead time, undermining the current balance between revenue received from incremental outputs, weighed against the risk of buy-back to ensure against inefficient investment in the system. Both proposals therefore destabilise the relevant objective (a) the efficient and economic investment in the system, through providing a means by which Transco can circumvent its incentives.’*

*In addition SSE made the following comment. SSE stated ‘We do concede that further consideration might need to be given to the three year lead time because in some circumstances there can be a requirement for a longer timescale to build a physical asset. However if Transco has an issue with this timing it is for consideration at the next price control.’*

### **11.4 Clarity of legal text and revised IECR**

Two respondents (BGT, SSE) made specific comments.

*BGT commented ‘The proposed legal text of this Modification nor the revised wording of the IECR does not provide sufficient clarity of the precise conditions where such departure*

*would be acceptable. The parameters for such exceptions has not been discussed in the context of the amendment of the IECR and is not something that can be discussed, designed, agreed and implemented in the timescale facilitated under this Urgent Modification Proposal.'*

SSE made the following comments:

*'Reference should be to "Principal" Document.*

*It is not clear to us in the legal drafting proposed for 2.2.3(c)(i) which provisions of the IECR would apply. In the event that Ofgem directs implementation of this proposal this clause needs to be far more specific and make explicit reference to the IECR. We are also unclear how this amendment would apply to new ASEPs and would welcome further explanation given that they do not have a baseline.'*

Note: The amended legal text seeks to address the comments. It is suggested that Transco NTS considers the final comment above.

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

No comments were received on this aspect.

**13. The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence**

No comments were received on this aspect.

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

No programme of works has been identified

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

The Proposer has identified an implementation date of 15 August 2005.

**16. Implications of implementing this Modification Proposal upon existing Code Standards of Service**

No comments were received on this aspect.

**17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel**

At the Modification Panel meeting held on 8th August 2005, of the ten Voting Members participating one voted in favour of recommending implementation of this Modification Proposal. Therefore no recommendation was made.

**18. Transporter's Proposal**

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

**19. Text**

**Transportation Principal Document Section B**

*Amend paragraph 2.2.3(c)(i) to read as follows:*

- (i) the relevant number of incremental amounts (each being for a different amount) of Quarterly NTS Entry Capacity greater than the Baseline Entry Capacity (the maximum incremental amount being the lower of (1) an amount not less than an amount equal to 150% of NTS SO Baseline Entry Capacity and (2) an amount determined by the application of Transco NTS's Incremental Entry Capacity Release Statement) (each amount an "**incremental capacity amount**"); and

*Amend paragraph 2.2.18(d)(v)(1) to read as follows:*

- (1) the relevant number of incremental capacity amounts of Quarterly NTS Entry Capacity greater than the NTS SO Baseline Entry Capacity (the maximum incremental amount being the lower of (1) an amount not less than an amount equal to 150% of NTS SO Baseline Entry Capacity and (2) an amount determined by the application of Transco NTS's Incremental Entry Capacity Release Statement); and

Subject Matter Expert sign off:

*I confirm that I have prepared this modification report in accordance with the Modification Rules.*

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

**Tim Davis**  
**Chief Executive Joint Office of Gas Transporters**

Signature:

Date :