Modification Report
Limitation on offering for sale unsold capacity
Modification Reference Number 0037
Version 2.0

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 Ofgem considered that if this Proposal and Modification Proposal 036 'Limitation of incremental capacity offered in QSEC auctions' were to "follow non-urgent procedures, it is 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:

"It is proposed that Transco NTS should not be obliged under the Uniform Network Code (UNC) to make Unsold NTS Entry Capacity ("unsold capacity") available to Users at an Aggregate System Entry Point (ASEP) when the following criteria are met:

Transco NTS assesses there is a significant risk that it will not be able to physically deliver all or part of the unsold capacity from the capacity allocation date. This would typically be caused by the length of time required to obtain consents or construction challenges, both of which may be beyond the full control of Transco NTS; and

Transco NTS assesses there is an expectation that previously allocated capacity at the ASEP would need to be bought back.

However, Transco NTS, in making its assessment as to whether to release unsold capacity in accordance with such criteria, would still need to ensure that it was able to meet Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of its Transporters Licence to "use all reasonable endeavours to offer for sale" all obligated entry capacity. Transco NTS therefore believes that the criteria proposed to be included within the UNC when considered in combination with its Licence obligations would result in unsold capacity not being released only in exceptional circumstances.

Under such exceptional circumstances, Transco NTS considers that the total level of buy-back costs is likely to be higher, than would otherwise be the case, if the unsold capacity is offered for sale and would be above that considered to be efficient and economic. This would particularly be the case in the event that Users purchase the unsold capacity solely on the expectation that they would receive buy-back payments. 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.

If this Proposal were to be implemented, Users would be notified that Transco NTS is not releasing unsold capacity through the relevant annual or rolling monthly invitation process for the long and medium auctions, or by 12:00 ahead of the gas day for daily auctions.

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

The Proposer considered "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 avoiding the potential increase in buy-back costs incurred by both Transco NTS and Users above that which would be considered to be economic and efficient."

Other comments were expressed as shown in the quotations within this and other sections of this report.

E.ON UK Stated that "Both [0036 and 0037] 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."

SGD stated that it "…cannot concur with Transco's assertion that avoiding potentially high buy back costs is consistent with efficiency. We consider that the major changes proposed here undermine effective competition between shippers and therefore do not further the relevant objectives of the UNC.

SSE stated that “Restricting access to Unsold NTS Entry Capacity is also a barrier to new entrants and therefore detrimental to competition in shipping and supply.”

MLCE Stated that “Overall this proposal does not better facilitate the relevant objectives, as the buy back risks appear overstated and Transco have not demonstrated why these risks have suddenly increased. The proposal shifts risks from Transco to shippers in a way that forces more shippers to buy capacity in the long term auctions rather than being able to manage portfolios by a mix of long and short term capacity release. The shift of focus toward long term auctions will discriminate against some shippers and reduce the level of competition between shippers.

MLCE considers that there are already sufficient measures in place that allow Transco to manage unexpected problems from planning and building new infrastructure and that any significant issues should be discussed with Ofgem. Further, Transco should state why the risk levels have changed and why other solutions such as using the next price control to reset the baseline levels or re-negotiate its incentives are not preferable to introducing discriminatory solutions that increase the risk and uncertainty for shippers.”

In respect of the above paragraph, the SME notes that the Proposal has been put forward on the principle that it would be applied on a consistent basis to all ASEPs and future system entry capacity auctions, and on that basis, would not appear to be discriminatory.

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

The Proposer did not "believe this Proposal, if implemented, would adversely impact upon security of supply, operation of the Total System, or industry fragmentation.”

Transco NTS “does not believe this Proposal, if implemented, would adversely impact upon security of supply, operation of the Total System, or industry fragmentation.”

Other comments were expressed as shown in the quotations within this and other sections of this report.

SSE stated that this proposal raised significant issues “such as security of supply, the commercial impact on shippers and the ability of shippers to land gas to meet the needs of their customers.” In particular, SSE “query the impact that this proposal would have on withdrawal of gas from storage facilities. Because the need for NTS entry capacity to withdraw gas is typically seasonal we conclude that not to make unsold capacity available would inevitably be detrimental to security of supply if shippers cannot get access to unsold capacity in the shorter-term.”

CSL stated that it “..feels that reducing shippers opportunity to purchase entry capacity (for both RMSEC and DADSEC) runs contrary to the original intent of the incentive mechanism and will detract Transco from providing timely system enhancement and security of supply.”

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

a) implications for operation of the System:

The Proposer did not "believe this Proposal, if implemented, would adversely affect the operation of the System."

Other comments were expressed as shown in the quotations within this and other sections of the report.

STUK stated that certain ".. shippers have chosen to participate in the long term auction based on … [assumptions] …. While the regime cannot be expected to remain static STUK believe that this proposal will undermine the auction process and fundamentally change the nature of the base line product made available by Transco. It has always been clear that the baseline levels of capacity should be made available and that Transco should manage delivering against this capacity through the buyback market. If Transco needs to invest to meet this capacity level it has a choice to invest or buy back the capacity either on the day or through forwards and options contracts. Therefore Transco already has a number of mechanisms in place to manage its exposure to baseline capacity provision.

The addition of these two elements for avoiding the release of unsold capacity will undermine the capacity product as it bases the availability of the remaining unsold capacity on an assessment by Transco that it cannot physically deliver such capacity. No information is given as to what such an assessment would be or any criteria to objectively test if this is the case. This will not better facilitate the economic and efficient operation of the NTS pipeline system as it could lead to increases in the cost of short term capacity auctions or on the secondary market as Transco limit the level of capacity available to the market (potentially creating the prospect of over recoveries as seen when Transco limited the level of capacity available based on demand levels). Such increases would inevitably be passed on to consumers."

The SME notes that the Proposal aims to address situations where Transco NTS has no choice whether to invest or buy-back capacity due to the circumstances identified in the proposal. In the event that Transco NTS would find itself unable to complete the required investments on time, then it believes that it would have no choice but to buy-back the capacity.

b) development and capital cost and operating cost implications:

The Proposer considered 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 unsold 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."

Other comments were expressed as shown in the quotations within other sections of this report.

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

The Proposer did not "believe this Proposal, if implemented, requires it to recover any additional costs."

Other comments were expressed as shown in the quotations within other sections of this report.

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

The Proposer did not "believe this Proposal, if implemented, would have any consequences on price regulation."

Other comments were expressed as shown in the quotations within this and other sections of this report.

SSE stated that "Transco NTS has provided no information about the impact that this proposal would have on its ability to recover TO Allowed Revenue in respect of unsold capacity that comes within the baseline. Our interpretation of the UNC definition of Unsold NTS Entry Capacity is that it includes all categories of firm entry capacity, from QSEC to DSEC. This means that if this proposal were implemented Transco would be entitled to withhold for sale the 20% of baseline capacity held back from the long-term auctions for sale in the AMSEC auctions plus any unsold baseline from the QSEC auctions. What impact might this have on the TO revenue recovery position? We therefore disagree with Transco's assertion that this proposal does not impact on price regulation."

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

"Transco NTS believes that this 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 specific circumstances."

Other comments were expressed as shown in the quotations within this and other sections of the report.

RWE npower stated "In the absence of auction signals creating physical rather than financial capacity rights, the capacity regime was designed to maximise capacity made available to Users. This proposal undermines this fundamental principle. 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. We hope to discuss this matter as part of the upcoming Transmission price Control Review."

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

The Proposer did not "envisage any impact on the UK Link System if this Proposal were to be implemented."

No other views were expressed.

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

The Proposer considered 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."

Other comments were expressed as shown in the quotations within this and other sections of this report.

Risks and rewards under Transmission Incentive Mechanisms

E.ON UK stated "Ofgem state in their initial consultation on Transmission price control review, the importance of ensuring 'licensees bear an appropriate share of the risk of underperformance under the price controls in relation to, for example, the cost of buying back capacity rights if investment by a licensee is not focused and timely'. These modification proposals weaken such fundamental incentives.

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.

In proposal 036, Transco state that changes to the UNC are necessary to reflect changes to the Incremental Capacity Release (IECR) Methodology Statement. In our response to the changes proposed to the IECR Methodology Statement, we expressed our concerns with changes proposed to investment lead times. We have not had the opportunity to see other representations or objections to the proposals. Under Special Condition C15(10)(b), we request a copy of each statement and report prepared pursuant to paragraphs 2, 3, 4, 5, 6 and 7 of that condition. We are surprised that we have to specifically request to see representations to the consultation on the IECR Methodology Statement, as with most consultations, such information is publicly available to ensure transparency and accountability in the process."

In respect of the above quotation, the SME notes that the Transco NTS document "IECR Review 2005 – Report on Consultation Responses" was circulated on 26th July 2005; i.e. after the close out date for representations on this Proposal.

E.ON UK noted "It is regrettable that we have not had the opportunity to consider these proposals in an earlier development stage where it would no doubt have become clear that the proposals would be better addressed through Ofgem's consultation on Transmission price control review and could have been raised as a specific question in that consultation. We would urge Transco to raise any issues with investment lead times and associated revenue, in their response to that consultation."

SSE stated " Our understanding of the TO and SO incentive regime framework for the NTS entry capacity regime is as follows:

> Transco must release for sale a volume of baseline capacity, for which it receives TO allowed revenue. However, under this urgent modification proposal Transco would not even be required to release unsold baseline capacity. In our view therefore, if this proposal were to be implemented Transco would be in breach of its licence obligations; and

> In response to the signals received via the auctions, coupled with other planning information, Transco will determine whether or not to release additional, incremental "obligated" capacity for which it receives SO incentive revenue. The decision as to whether or not to release obligated will be influenced by Transco NTS's assessment of the reward of releasing the incremental capacity vs the buy back risk. It should be noted that the entry capacity product sold in the auctions is a financially firm product. It is up to Transco NTS to determine whether or not to invest in a physical asset to underpin that financially firm right. We therefore disagree with Transco's reasoning that its obligation to release unsold entry capacity should be curtailed in circumstances where it considers there to be a significant risk that the capacity offered for sale cannot be physically delivered.

We believe such an approach would undermine significantly undermine the existing basis on which capacity is made available, offered and delivered as well as the incentives regime."

In respect of the quotation in the first bullet point above, the SME notes that Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of the Transco NTS Transporters Licence obliges Transco NTS to "use all reasonable endeavours to offer for sale" all obligated entry capacity. If this Proposal is to be implemented, Transco NTS would appear be required to meet the licence obligation prior to making any decision whether or not to release unsold capacity. The Proposal, if implemented, would therefore appear to be compatible with the Transco NTS licence obligations.

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.

BGT were "particularly concerned by the second bullet point under the "Nature and Purpose of Proposal". If capacity has been allocated to a User within the LTSEC process it cannot and should not be simply withdrawn or offset by a reduction in baseline capacity available. Following allocation of incremental capacity, Transco NTS will make a risk assessment about the investment required to meet this additional requirement. Should Transco NTS assess that previously allocated capacity would need to be bought back, it infers that the system capability has already been oversold without the requisite investment being made. In such circumstances we believe that they should be exposed to a greater, not lesser, proportion of those buybacks."

The SME would note that the Proposal does not appear to allow Transco NTS to withdraw any previously allocated capacity.

BGT believed that "the incentive arrangements relating to release of System Entry Capacity should also reflect any inability of the Transporter to meet commitments made in the LTSEC process. This should include a direct exposure to the risk, not shared with the community or recoverable through transportation charges."

SGD noted that the “urgent modification proposal … proposes that Transco NTS's current obligations to offer unsold capacity be limited when certain criteria are met, namely that there is a risk that Transco will be unable to deliver the capacity or that there will be high buy back costs.

SGD considered "this proposal to contain major changes in approach from that originally implemented for the LTSEC auctions and the incentives on Transco. Transco has been given a number of complex incentives in its price control to encourage it to maximise available capacity and to take on risk when it cannot deliver capacity sold. Transco accepted these incentives but now appears to be responding to them not by making investment or finding other commercial solutions but by changing the arrangements themselves. This is inconsistent with the "commercial" approach envisaged for Transco to take.”

SGD also noted that "when the LT auctions were put in place, Ofgem stated that it expected shippers' exposure to buy back costs to reduce over time. If Transco's concern is shippers' exposures, it would seem sensible to change the sharing factors to reduce these. However, it appears to us that it is more likely that Transco's concern is its own exposure and the effect that this could have on its incentive package.”

MLCE noted that “Transco appear to want a change that allows it to avoid meeting its obligations where in its view circumstances become difficult or where it assesses there is a risk of capacity buy back. Neither of these circumstances appears to represent a strong enough case for Transco to shift risk from itself to the shipping community. MLCE does not support this modification as Transco have not shown why its risks are now greater, and why this solution better facilitates the relevant objectives.

For the first criteria:

> Transco NTS assesses there is a significant risk that it will not be able to physically deliver all or part of the unsold capacity from the capacity allocation date. This would typically be caused by the length of time required to obtain consents or construction challenges, both of which may be beyond the full control of Transco NTS.

Transco seems to be describing the normal risks involved in infrastructure projects. This is one of the reasons why it is allowed a period of up to three years to deliver on incremental capacity builds. If Transco is unable to meet the baseline entry capacity then it needs to demonstrate to the industry what factors have changed to increase the risk of non-delivery. This proposal provides no rationale for why Transco would not be able to meet its baseline obligations and therefore no reason to curtail the sale of capacity.

Further, the proposal notes that shippers would be informed of curtailed sales at the auction invitation time, or 12:00 ahead of the day for the daily auctions. This timing does not match with the first criteria, as project planning and construction delays will be known well in advance of any auction procedures. If this modification is approved Transco should have to provide far more information on delays and problems so that shippers are able to better assess the likelihood of curtailment to capacity sales.

For the second criteria:

> Transco NTS assesses there is an expectation that previously allocated capacity at the ASEP would need to be bought back.

It is difficult to understand why this criterion necessitates curtailing the sale of unsold entry capacity. The buy-back risk has already been incorporated into the risk reward framework negotiated by Transco at the last price control. Attempting to change this prior to the next price control requires a higher level of evidence that the system is unmanageable.

Reasoning that with an expectation of buy-backs, shippers will be encouraged to buy unsold capacity in order to benefit from Transco's stress is quite implausible for a sustained period of time. Firstly, if this scenario was in any way believable, a competitive market would increase the cost of unsold capacity toward the cost of buy-back in order to eliminate the arbitrage. Secondly, playing an entry capacity game with Transco has a number of risks for shippers. Transco will know whether a shipper intends to flow gas against this capacity. Should a shipper not have any gas to flow then Transco are more likely to be able to fulfil its other firm entry capacity obligations by allowing the value of 'gas-less' capacity to expire.

If a shipper buys capacity and has gas to deliver, there are a number of costs associated with switching delivery to other entry points (something many could not even do). These costs are likely to outweigh any potential benefits of selling capacity back to Transco. Such shippers would also need to compete with other capacity holders to sell capacity back."

MLCE were "puzzled by why Transco considers that its risks have suddenly shifted. Changing flow patterns on the system may imply a need for greater investment and reinforcement to meet some baseline capacity levels, but Transco have not raised this (or anything else) as a reason for the increased risks. It appears that shippers must simply accept that less flexibility is a good thing for the industry."

MLCE considered that "Transco have not provided a strong enough case for this modification. It is seeking to shift risks from itself to shippers based on weak criteria that rely on Transco assessment. The risk on shippers increases as they will be less able to tell when capacity will be made available outside of the long term auctions."

Total understood "Transco NTS's concern with regard to being required to sell additional capacity when it believes there is a significant risk that it will not be able to physically deliver all or part of the unsold capacity from the capacity allocation date. However, for auctions that have not yet been held, we see this risk being addressed by modification proposal 0036 to which we have given our qualified support."

The SME notes that Modification Proposal 0036 would only allow Transco NTS to not release incremental capacity under certain criteria. This Modification Proposal 0037 seeks to avoid release of "unsold capacity", which is not covered by Modification Proposal 0036.

CSL noted that "Transco is incentivised to invest in infrastructure to allow delivery of capacity, or alternatively it may elect to avoid investment and take the risk of facing buy back costs. CSL believes that the proposed modification would serve to drastically alter the balance of risk and reward for Transco. We do not believe it is appropriate for changes to Transco's incentive arrangements to be achieved through changes to the Uniform Network Code."

CSL also disputed "Transco's use of the term "inefficient levels of buy back costs". In our view, high levels of buy back costs are generally a result of inefficient investment in providing entry capacity. Transco should not be afforded protection from its own decisions to not invest or its inability to deliver projects in reasonable time."

SGD stated that "..this proposal, along with urgent proposal 0036, reinforces our view that an auction-based regime contains a high degree of regulatory uncertainty and that a simpler approach may provide better outcomes for the industry and, ultimately, for gas consumers."

SSE noted "if Transco NTS's reasonable assessment is that the risk of buy back costs increasing is so high it should surely seek to renegotiate the buy back element of its incentive scheme with Ofgem."

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

Comments were expressed as shown in the quotations within other sections of this report.

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

Comments were expressed as shown in the quotations within this and other sections of this report.

SSE queried "the impact this proposal would have on shippers' abilities to meet customer demand and their bidding strategies. Some shippers may have decided not to purchase capacity in the long-term auctions in the knowledge that a certain volume of baseline would be released via the AMSEC auctions. Shippers intending to fine-tune their positions would have that option withdrawn from them. This is completely at odds with our understanding of the licence obligations placed on Transco which were designed to ensure that all unsold capacity was made available to market, particularly capacity that is accounted for under the TO revenue stream."

The SME notes that Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of the Transco NTS Transporters Licence obliges Transco NTS to "use all reasonable endeavours to offer for sale" all obligated entry capacity. Transco NTS would not appear to have to release unsold capacity if it can demonstrate that it has met this obligation.

BGT stated "We are of the opinion that the nature of capacity released within the LTSEC process must be reliable and unambiguous. Users must have the certainty that their requirements for System Entry Capacity will be met when bidding in the process. The only variance to this must be where there are exceptional conditions that meet pre-determined criteria and this is made known to participants in the process in advance of their submitting bids. Once the allocation has been made, Users must be able to rely on that capacity being available, as they will have made significant commercial commitments based upon this availability."

BGT also stated that "The Transporters licence … obliges [Transco NTS] to make available 100% of baseline in the AMSEC, RMSEC and daily auctions up until D-1. Capacity below baseline is obligated and there must be no restriction of its availability, as to do so would radically alter the incentive structure built around capacity release."

In respect of the above quotation, the SME reiterates that Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of Transco NTS's Transporters Licence obliges Transco NTS to "use all reasonable endeavours to offer for sale" all obligated entry capacity.

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

Advantages of the Proposal

The Proposer believed that "this Proposal, if implemented, would

avoid potentially increasing buy-back costs that are already expected to arise as a result of previously allocated capacity at an ASEP above that which would be considered to be efficient and economic; and

remove the potential for Users to seek to obtain unsold capacity solely on the expectation that it will receive buy-back payments."

Disadvantages of the Proposal

The Proposer recognised that implementation of "this Proposal may limit the amount of unsold capacity that is made available to Users. However, Transco NTS believes that this is necessary in the specific circumstances set out in this Proposal.

It is recognised that this Proposal relies upon Transco NTS assessment of the likelihood of capacity not being physically delivered on time and the potential for buy-back of previously allocated capacity for the affected ASEP. It is also difficult to specify an exact level of risk applicable to all ASEPs and circumstances above which unsold capacity would not be made available. However, in the event that Transco NTS does not make unsold capacity available, were this Proposal to be implemented:

Transco NTS would still require to ensure it was able to meet Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of its Transporters Licence to "use all reasonable endeavours to offer for sale" all obligated entry capacity; and

Transco NTS would limit its opportunity to earn entry capacity investment incentive revenue under Special Condition C8B Part 2 paragraph 14(5) of its Transporters Licence, unless the incentive cap had already been met for the relevant year."

Other comments were expressed as shown in the quotations within other sections of this report.

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

Responses were received from:

E.ON UK Plc	(E.ON UK)	Not in Support
Scottish and Southern Energy plc	(SSE)	Not in Support
British Gas Trading Ltd	(BGT)	Not in Support
Statoil (UK) Ltd	(STUK)	Requires debate
RWE npower plc	(RWE npower)	Not in support
Shell Gas Direct Ltd	(SGD)	Not in support
Merril Lynch Commodities (Europe) Trading Ltd	(MLCT)	Not in support
Total Gas & Power Ltd/Total E&P UK plc	(Total)	Not in support
Centrica Storage Ltd	(CSL)	Not in support
ENI UK Ltd	(ENI)	Not in support
Transco plc Transmission	(Transco NTS)	In support

Two confidential responses were also received, neither of which supported implementation of this Proposal.

Comments were expressed as shown in the quotations within this and other sections of the report.

Timing/urgency

SSE challenged "the justification made for urgency" and is surprised that "… it has been afforded urgent status, with less than a week for respondents to comment on the issues. The timescale is particularly worrying given the significant issues that this proposal raises, such as security of supply, the commercial impact on shippers and the ability of shippers to land gas to meet the needs of their customers."

SGD was "…surprised that this proposal has been raised so close to the expected time of the LTSEC auctions. We must also raise concerns about such a significant proposal being given urgent status with less than a week to comment, particularly over a holiday period. We do not consider this provides a transparent process."

STUK did not "feel that this modification warranted urgent status, while the approval of the modification would directly affect the forthcoming capacity auctions it relates to much wider issues which are still under review and will be subject to further review through the NTS price control. This modification should be considered over a longer time frame than the current timetable allows and should therefore not be implemented at such short notice."

Use of the UNC mod process for this proposal

SSE stated "With regard to the ability of Transco NTS to physically deliver the unsold obligated capacity offered as QSEC within the three year timescale again we would note that this changes the whole basis of the incentive framework that was agreed at the time of the last price control review. We therefore query whether it is appropriate for this change to be pursued under the UNC governance arrangements."

SSE also stated "..if the level of buy back costs to be incurred as a result of releasing unsold entry capacity is inefficient this suggests that either the baseline levels were set too high, or that Transco's decision to release incremental obligated capacity has not been efficient. If the volumes that have been allocated as obligated are inappropriate this suggests a need to revise the IECR and not the UNC."

Total stated "Where capacity has been sold in previous auctions, then this has been offered on the network code terms applicable at the time of that auction and parties bidding for capacity have made firm financial commitments on the basis that the capacity would be available or would be bought back, if unavailable. Any such decisions have also been made on the understanding that, at all times, capacity up to baseline would be offered in one or more auctions and that where obligated entry capacity was released (either as annual or permanent) then any unsold capacity would also be offered for the appropriate periods in future auctions. It is therefore unacceptable for changes to be introduced that would retrospectively affect the value of such capacity. In fact, we believe it is a licence obligation that such capacity should be offered in one or more auctions and we therefore do not understand how the UNC can be changed unless the licence is also changed."

SGD stated "If Transco has significant concerns regarding the LTSEC auctions, buy back arrangements and associated incentives, it should have brought these to the attention of the industry before raising urgent proposals. We do not consider the UNC route to be the most appropriate route for resolution of these issues. We are not convinced that this proposal is consistent with Transco NTS's licence obligations to release any unsold entry capacity to the market."

SSE stated "In our opinion this proposal represents an abuse of the governance process and we do not understand why Transco NTS has left it so late to bring this proposal forward."

SSE believed that "the issues of concern to Transco NTS are not matters to be resolved via a UNC modification proposal. Rather, we are firmly of the view that this proposal is at odds with our understanding of Transco NTS's licence obligations to release unsold entry capacity and that any issues that Transco NTS has with these obligations should be addressed via licence modification/price control negotiations with Ofgem. It is not appropriate to use the UNC as a means of "getting round" the licence obligations.

Given this statement we do not understand why Transco is seeking to address its concerns with licence obligations via a UNC modification proposal. Indeed, in doing so, Transco NTS would appear to be avoiding due process. Furthermore that it would appear reasonable to assume that unless it is more efficient or economic to buy back Transco would physically provide the capacity."

E.ON UK did "..not consider that changes proposed to the allocation of incremental entry capacity ought to be addressed through a UNC modification proposal". …"How any incremental capacity is then released post the auctions should be dealt with through Transco's incentives, in connection with the IECR Methodology Statement."

E.ON UK also stated "Transco originally sought to place these market rules into these non Code documents to avoid the possibility of frequent changes to the arrangements and to agree a longer term settlement with the regulator on incentives. They cannot now choose to opt certain rules back into the Code because they now feel they are unable to fulfil their contractual obligations to shippers with respect to incremental capacity. Transco should be required to continue to use the agreed buy-back mechanism."

SGD stated "Overall, the effect through the capacity neutrality arrangements should be neutral and we see no reason to suggest that there would be any effect on end-consumer prices. Transco is not clear about what it means by "inefficient" levels of buy back costs and we can only assume that they have equated "inefficient" with "high". We do not see any justification for this approach. We note that Transco NTS has benefited from the incentive arrangements when it was able to sell capacity without additional investment: it would appear that when it has a potential financial exposure, Transco's approach differs. Any other concern about "inefficiency" should be raised with Ofgem direct in respect of baseline levels or other areas of concern. By accepting the licence conditions, we consider that Transco has accepted a package which it should not be attempting to change through the UNC route."

CSL stated "Firstly CSL would like to comment that it is disappointing the modification was not raised at an earlier stage. The compressed timescale for consultation means that shippers have little opportunity to assess the potential advantages and disadvantages of the proposal. We are not aware of any change of circumstance or other modification which could have caused this modification to be raised at this time with urgency. We urge the Authority and industry to consider a review of the urgent modification process to ensure modifications cannot use the existing urgent status 'rules' to circumvent more transparent modification routes involving greater industry scrutiny. "

BGT stated "We are concerned at the manner in which these proposals have been raised. There are a number of documents and issues which must be considered in relation to these matters:-

Transporters licence obligations

Transporters operational procedures (IECR, PG, SMPS etc)

Transporters incentive arrangements

Transporters common contract with the users of their networks (Uniform Network Code)

These modification proposals deal only with the latter of these points and therefore address only part of the issue. 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.

…the arrangements for offer of System Entry Capacity are governed by a number of documents. The amendment of one does not in itself constitute a reason for urgency in bringing the other elements in line. 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."

The SME notes that Transco NTS presented a package of changes to the UNC at the Transmission Workstream meeting on 6th July 2005 following the receipt of Shipper views on the initial IECR proposals. Transco NTS believes that it sought to take account of the comments and suggestions raised at this meeting.

Quantification/cost benefit

SSE commented that " ..Transco states that without these provisions in place there could be an adverse commercial impact on Transco NTS and Users as a result of potentially high buy back costs at Aggregate System Entry Points (ASEPs) We note that Transco NTS has made no attempt to quantify the extent of the commercial impact, nor has it indicated the volumes of capacity that could be involved."

ENI stated that “the current modification is unacceptable because it does not provide a detailed cost-benefit analysis for its implementation and because the criteria for withholding any unsold capacity are not clear and transparent.”

SSE noted that "Transco has not provided any evidence to support its concerns that the cost of buy back is going to be so high therefore it is impossible for us to quantify the consequential risks that shippers would face.”

ENI felt that "Transco NTS have not fully demonstrated why this modification is required, the only issue they highlight is the “potentially high buy-back costs at specific Aggregated System Entry Points” that Transco NTS and Users may incur if the modification is not implemented. Eni believe that any significant change in the Enty Capacity regime should be properly considered and that Transco NTS should provide detiled reasoning with a full cost benefit analysis why they believe Users may face “potentially high buy-back costs”

Criteria for not offering unsold capacity for sale

CSL considered "the trigger events for Transco NTS to restrict the release of unsold capacity are arbitrary, subjective and difficult for shippers to challenge and place undue emphasis on the Authority to monitor the use of the powers this modification proposes to grant the relevant transporter.”

RWE npower stated “The interactions between this proposal, the 2002 ~ 2007 Price Control settlement and the Transco NTS incentives has not been explained. It is hard to see how it will fit in with the baselines remunerated under the Price Control. Under the proposal, Transco NTS would have considerable flexibility in how it meets its various licence obligations related to capacity release and there is little clarity defined over the decision-making mechanism. To allow them to 'reasonably assess' circumstances where they may be unable physically to deliver capacity is not acceptable.”

ENI were "concerned that Transco NTS’s modification proposal to limit the offering of unsold capacity are based on criteria which are only assessed by Transco NTS. Eni do not consider that this is an appropriate mechanism and we would prefer to see a mechanism which is clear and transparent to all market players and not just based upon Transco NTS’s own assessment.”

SSE stated In proposed 2.1.5 (c) (iii) (i) it all seems to be down to Transco discretion. How is such discretion to be audited. Who will decide whether Transco’s assessment is reasonable? What information will be provided to shippers?

The references to consents, lead times and construction challenges are irrelevant and misleading.”

Competition law aspects

SGD noted “Transco suggests that an exceptional circumstance could be in the event that shippers "purchase capacity solely on the expectation that they would receive buy back payment". It may be that some shippers have already calculated that this is an efficient approach. We note that Ofgem has stated that it would have no specific regulatory concerns with shippers taking such an approach, and saw benefits with increased liquidity. As Transco knows, it is not the case that if it needs to make significant buy backs that all shippers will face costs equally as those who have sold back the capacity in the first place will have revenue to balance out these costs. Ofgem made clear that shippers would need to ensure that any "speculative" purchases of capacity need to be within competition law, financial services regulations and licence obligations. If Transco has concerns in these areas, they should raise them direct with Ofgem and/or the appropriate regulatory authority."

SSE stated "It is not for the UNC to remove the potential for shippers to obtain unsold capacity solely on the expectation that they will receive buy back payments. If Transco considers that a party is abusing its position, there are licence and Competition Act provisions to guard against this."

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

No such requirements have been identified.

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 such requirements have been identified.

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

No such requirements have been identified.

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

The Proposer has suggested that this Modification Proposal should be implemented on 15 August 2005

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

No such implications have been identified.

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

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

B SYSTEM USE AND CAPACITY

Amend paragraph 2.1.5 to read as follows:

"2.1.5 In respect of an Aggregate System Entry Point and in relation to a Day in a calendar month in a Formula Year:

(a) ……….;

(b) ……….;

(c) ……….;

(i) ……….;

(ii) ……….;

(iii) ……….

an obligation to make available (in accordance with the procedures set out in this paragraph 2) to Users pursuant to paragraph 14(5)(f) of Part 2 of Special Condition C8B of Transco NTS's Transporter's Licence as, in the case of NTS Entry Capacity to be made available under paragraphs 2.2, 2.3 and 2.4 but not paragraph 2.5, set out in Transco NTS's Transportation Statement~~.~~; provided that:

(i) Unsold NTS Entry Capacity in each case shall not include any NTS Entry Capacity which Transco NTS reasonably assesses it may be unable to physically deliver for any reason if such NTS Entry Capacity were to be allocated at a given Aggregate System Entry Point, including for example, due to the length of time required to obtain consents or construction challenges; and

(ii) Unsold NTS Entry Capacity in each case for a particular Aggregate System Entry Point shall be zero where Transco NTS reasonably assesses there is an expectation that Transco NTS would be required to accept daily capacity offers pursuant to paragraph 2.10 in respect of previously allocated NTS Entry Capacity at that Aggregate System Entry Point.

Amend paragraph 2.1.6 to read as follows:

2.1.6 For the purposes of the application of paragraph 2.6, the amount of Unsold NTS Entry Capacity in existence at a particular time will, unless expressly stated otherwise, be calculated by reference to a continuing obligation to make available Firm NTS Entry Capacity through the application of paragraph 14(5) of Part 2 of Special Condition C8B of Transco NTS's Transporter's Licence prior to the time at which the amount of Unsold NTS Entry Capacity is to be ascertained~~.~~; provided that:

(a) the amount of Unsold NTS Entry Capacity in existence at a particular time shall not include any NTS Entry Capacity which Transco NTS reasonably assesses it may be unable to physically deliver for any reason if such NTS Entry Capacity were to be allocated at a given Aggregate System Entry Point, including for example, due to the length of time required to obtain consents or construction challenges; and

(b) the amount of Unsold NTS Entry Capacity in existence at a particular time for a particular Aggregate System Entry Point shall be zero where Transco NTS reasonably assesses there is an expectation that Transco NTS would be required to accept daily capacity offers pursuant to paragraph 2.10 in respect of previously allocated NTS Entry Capacity at that Aggregate System Entry Point.

Amend paragraph 2.4.10 to read as follows:

2.4.10 Where there is no Available Daily Capacity in respect of an Aggregate System Entry Point for a Day, or the amount thereof is less than the minimum eligible amount, Transco NTS will not accept any daily capacity bids. Where, following the application of paragraph 2.3, there remains Unsold Entry Capacity in relation to an Aggregate System Entry Point in respect of a Day but, as a result of the operation of paragraph 2.1.5 or 2.1.6, the Unsold NTS Entry Capacity in relation to that Aggregate System Entry Point in respect of that Day is less than that remaining after the application of paragraph 2.3, then Transco NTS shall notify Users of the Available Daily Capacity in relation to that Aggregate System Entry Point not later than 12:00 hours on the Preceding Day to that for which the Daily NTS Entry Capacity is being offered."

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 :