

Stage 04: Final Modification Report

What stage is this document in the process?

0382:

Reducing the capacity element of LDZ system charges for SSPs

- 01 Proposal
- 02 Workgroup Report
- 03 Draft Modification Report
- 04 Final Modification Report

LDZ system charges are weighted 95:5 between capacity and commodity. This modification seeks to amend this to 50:50 for SSPs.



Panel did not recommend implementation



High Impact:

Cashflow impact, aligning costs and revenues



Medium Impact:

N/A



Low Impact:

Cashflow impact

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About this document:

This document is a Final Modification Report, presented to the Panel on 20 October 2011.



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1 Summary

Is this a Self-Governance Modification

Implementation would have a significant impact on smaller domestic suppliers in particular, and so does not meet the criteria for a self-governance modification.

Why Change?

The present LDZ charging arrangement is primarily based on capacity bookings, which are largely fixed throughout the year. Supplier revenue is driven by the amount of gas consumed, which is higher in winter than in summer. This creates a mismatch between supplier costs and revenues, and potentially makes the sale of gas a loss making activity during the summer months. This creates cashflow issues and is a barrier to entry.

Solution

It is proposed that, for Smaller Supply Points, the capacity element of the LDZ System charges be targeted to recover 50% rather than 95%, and the commodity element of the LDZ System charges is targeted to recover 50% rather than 5%, of the revenue from the LDZ system charges.

Impacts & Costs

Since the Transporters introduced a move to charging based on a 95:5 rather than 50:50, no significant systems impacts are anticipated if this is reversed. The Transporters funded all systems costs associated with the move to 95:5 and would similarly be expected to fund any costs which arise from a return to 50:50.

Implementation

The Proposer wishes to see implementation at the earliest possible opportunity.

Workgroup attendees suggested the timetable for implementing this modification should be consistent with the timing of changes to transportation charges but also provide a long lead time to allow the changed basis of charging to be reflected in the prices offered to customers.

The Case for Change

Implementation will facilitate competition by helping to ensure revenue and costs are more closely aligned, reducing the possibility of gas being supplied at a loss during the summer months and addressing a cashflow issue which can act as a barrier to entry and a barrier to business development for smaller suppliers in particular.

Recommendations

The Panel is invited to consider the Final Modification Report.

2 Why Change?

The present LDZ charging arrangement is primarily based on capacity bookings, which are largely fixed throughout the year. In the case of domestic suppliers, transportation charges are based on AQs which are set for a year and do not always reflect the true level of capacity usage, especially when energy efficiency measures are installed, reducing consumption without any immediate benefit through reduced capacity charges. By contrast, Supplier revenue is driven by the amount of gas consumed, which is higher in winter than in summer, and is reduced as a result of energy efficiency initiatives.

The mismatch between the profiles of supplier revenue and transportation charges potentially makes the sale of gas a loss making activity during the summer months. While this may not create particular difficulties for suppliers with large, diverse portfolios, or those with a low cost of capital, a significant cashflow issue is created for some suppliers. The issue is particularly acute for smaller suppliers with a primarily domestic customer base, and especially those that actively promote and encourage adoption of energy efficiency measures. The mismatch therefore creates an inappropriate barrier to market entry and business development, and change is needed to encourage greater competition within the domestic market.

3 Solution

It is proposed that, for Smaller Supply Points, the DN Transportation Charging methodology, as set out in Section Y of the UNC, is modified such that the capacity element of the LDZ System charges be targeted to recover 50% rather than 95%, and the commodity element of the LDZ System charges is targeted to recover 50% rather than 5%, of the revenue from the LDZ system charges.

4 Relevant Objectives

Implementation will better facilitate the achievement of **Relevant Objectives a and c.**

The benefits against the Code Relevant Objectives	
Description of Relevant Objective	Identified impact
a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;	Yes
aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: <ul style="list-style-type: none"> (i) no reserve price is applied, or (ii) that reserve price is set at a level - <ul style="list-style-type: none"> (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers; 	
b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;	
c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers; and	Yes
d) that the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).	

The Workgroup recognised that a move to 95:5 from 50:50 had been introduced following an Ofgem Impact Assessment. The two main justifications for not vetoing the change were:

Cost Reflectivity - *The GDNs considered that the cost information showed the majority of costs relate, either directly or indirectly, to the provision of capacity on the network and that only a small proportion relate to system throughput.*

Ofgem accepted that approximately 95% of Use Of System costs are unaffected by throughput but considered that some of the indirect costs were effectively fixed, varying with neither capacity nor throughput. However, Ofgem considered that the fixed costs should not be recovered on a commodity basis.

Improved Charge Stability and Predictability - The GDNs considered that the change would better align the effect of system throughput variations on allowed and collected revenue so reducing instability in charges and improving the predictability of charge levels.

Ofgem agreed that the change should almost entirely remove system throughput as a contributory factor to K and hence as a source of variability in charge levels and that this should provide greater stability in charge levels.

Some Workgroup participants, including all the transporters, continued to support this view and so believed a move back to 50:50 would not facilitate achievement of the relevant objectives. While a number of Workgroup attendees were relatively neutral regarding the proposed change, some believed that some factors had not been given sufficient weight previously and so a move to 50:50 is justified. They argued that cost reflectivity may be improved by implementation of Modification 0382 since capacity related costs are driven by peak demands, which arise in the winter. It is therefore more cost reflective for the collection of charges to be focussed on the winter months, when peak demand is more likely to arise.

Competition would also be facilitated by more closely aligning the profile of revenues and costs. This would remove the barrier to entry that smaller suppliers, in particular, face at present because of the mismatch between costs and revenues. This creates a cashflow problem, with cashflow being widely recognised as a major issue for smaller organisations and new entrants. The present arrangements can make supply to domestic premises loss making in the summer months, which is a strong deterrent to entry and customer acquisition during the summer months. Creating more appropriate incentives to acquire customers, to encourage energy efficiency, and to remove barriers to entry would facilitate the development of effective competition.

The modification does not conflict with paragraphs 2, 2A and 3 of Standard Special Condition A4 of the Transporter's Licence since any change in charges would be applied based on the methodology prevailing at the time.

In their respective responses, those parties not in support of the proposal such as Corona Energy, EDF Energy, National Grid Distribution, Northern Gas Networks, Scotia Gas Networks and Wales & West Utilities, believe that reverting back to a 50:50 split for the SSP sector would increase transportation charge volatility and reduce predictability, reduce cost reflectivity, potentially skew GDN revenues away from summer to winter months and provide a significant barrier to entry for competitors, especially smaller parties with active energy saving policies due to the heavier weighting in favour of the volumetric component, would potentially introduce a methodology which results in SSP charges that do not accurately reflect DNO costs, potentially introduce wider under / over recovery (k value) swings as a result of the relationship of temperature and throughput for SSPs with the potential to adversely affect the promotion of competition. Northern Gas Networks go on to argue that reversing changes made under DNPC03 for part of the market would mean that the GDNs would no longer be effectively discharging their licence obligations in respect of the non-discriminatory and cost reflectivity aspects. As a consequence these parties feel that the modification would fail to better facilitate the achievement of either relevant objective (a) or (c).

In providing comments, ScottishPower remain unsure (based on the proposal) as to the justification behind focusing solely on the capacity/commodity split for SSPs and are unable to see how a different arrangement for each market can consistently reflect the costs incurred by the transporters. With regard to relevant objective (c), they go on to challenge the proposer's statement that the change would facilitate competition by more closely aligning revenue and costs and thereby potentially removing barriers to market entry, as the proposal focuses on the SSP market only.

In their respective responses, those parties in support of the proposal such as First Utility, Opus Energy, RWE npower, SSE and Spark Gas Shipping believe that reverting back to a 50:50 split for the SSP sector would amongst other things, promote competition between gas suppliers by potentially lowering the market entry barrier, better align settlement costs with supplier billing, correct the 'imbalance' between gas throughput and customer charging profiles resulting in reduction in potential cash flow issues especially for new market entrants and would better align costs and revenue leading to a cash flow situation which reflects customer demand more accurately – a major consideration for smaller suppliers. As a consequence these parties feel that the modification would better facilitate the achievement of relevant objectives (a) or (c).

5 Impacts and Costs

Consideration of Wider Industry Impacts

Implementation would not be expected to have an adverse impact on wider industry developments.

Costs

Indicative industry costs – User Pays	
Classification of the Proposal as User Pays or not and justification for classification	
Transporters would need to ensure invoice calculations reflect their obligations. This is a Transporter responsibility and therefore this is not a User Pays modification. The basis for funding should be the same as that when Transporters introduced a 95:5 capacity:commodity split, with the transporters funding any costs faced by themselves.	
Identification of Users, proposed split of the recovery between Gas Transporters and Users for User Pays costs and justification	
Not applicable	
Proposed charge(s) for application of Users Pays charges to Shippers	
Not applicable	
Proposed charge for inclusion in ACS – to be completed upon receipt of cost estimate from Xoserve	
Not applicable	

Impacts

Impact on Transporters' Systems and Process	
Transporters' System/Process	Potential impact
UK Link	<ul style="list-style-type: none"> None
Operational Processes	<ul style="list-style-type: none"> None
User Pays implications	<ul style="list-style-type: none"> None

Impact on Users	
Area of Users' business	Potential impact
Administrative and operational	<ul style="list-style-type: none"> None
Development, capital and operating costs	<ul style="list-style-type: none"> Costs re-profiled
Contractual risks	<ul style="list-style-type: none"> None

Where can I find details of the UNC Standards of Service?

In the Revised FMR for Transco's Network Code Modification

0565 Transco Proposal for Revision of Network Code Standards of Service

at the following location:

<http://www.gasgovernance.co.uk/sites/default/files/0565.zip>

Impact on Users	
Legislative, regulatory and contractual obligations and relationships	<ul style="list-style-type: none"> None

Impact on Transporters	
Area of Transporters' business	Potential impact
System operation	<ul style="list-style-type: none"> None
Development, capital and operating costs	<ul style="list-style-type: none"> None anticipated
Recovery of costs	<ul style="list-style-type: none"> Re-profiling would occur
Price regulation	<ul style="list-style-type: none"> The Charging methodology would be modified
Contractual risks	<ul style="list-style-type: none"> None
Legislative, regulatory and contractual obligations and relationships	<ul style="list-style-type: none"> None
Standards of service	<ul style="list-style-type: none"> None

Impact on Code Administration	
Area of Code Administration	Potential impact
Modification Rules	<ul style="list-style-type: none"> None
UNC Committees	<ul style="list-style-type: none"> None
General administration	<ul style="list-style-type: none"> None

Impact on Code	
Code section	Potential impact
Section Y	Replace "95" and "5" with 50

Impact on UNC Related Documents and Other Referenced Documents	
Related Document	Potential impact
Network Entry Agreement (TPD I1.3)	None
Network Exit Agreement (Including Connected System Exit Points) (TPD J1.5.4)	None
Storage Connection Agreement (TPD R1.3.1)	None

Impact on UNC Related Documents and Other Referenced Documents	
UK Link Manual (TPD U1.4)	None
Network Code Operations Reporting Manual (TPD V12)	None
Network Code Validation Rules (TPD V12)	None
ECQ Methodology (TPD V12)	None
Measurement Error Notification Guidelines (TPD V12)	None
Energy Balancing Credit Rules (TPD X2.1)	None
Uniform Network Code Standards of Service (Various)	None

Impact on Core Industry Documents and other documents	
Document	Potential impact
Safety Case or other document under Gas Safety (Management) Regulations	None
Gas Transporter Licence	None

Other Impacts	
Item impacted	Potential impact
Security of Supply	None
Operation of the Total System	None
Industry fragmentation	None
Terminal operators, consumers, connected system operators, suppliers, producers and other non code parties	None

In its response, Corona Energy point out that similar to the majority of shippers active in the market, they supply both SSP and LSP customers (in their case, all non-domestic). Moving to a regime where SSP site costs are recovered through a 50:50 split and LSP costs through a 95:5 split will impact their ability to predict prices going forward and they will therefore incur costs in making the necessary adjustments.

In its response, First Utility believes that implementation would not cause any cost impacts and would provide considerable cash flow benefits to all SSP suppliers.

In its response, National Grid Distribution expects the implementation costs to be insignificant.

In its response, Scotia Gas Networks believe that there would be additional analysis and development costs within SGN and Xoserve to establish the new charges and

thereafter there would be additional ongoing costs associated with Transportation Pricing within SGN to calculate and monitor charges on a different basis for SSPs and LSPs. The ongoing costs within Scotia would be in the order of £10,000 pa.

In its response, ScottishPower do not believe that the proposal has been sufficiently developed in order for them to fully assess the impacts and costs, but do not perceive them to be material.

6 Implementation

While the Proposer was looking for immediate implementation, other Workgroup attendees supported the following:

On 1 April 2013 if an Ofgem decision is received on or before 1 February 2012;
On 1 April 2014 if an Ofgem decision is received on or before 1 February 2013; or
Within 18 months following receipt if an Ofgem decision is received after 1 February 2013.

These dates are proposed to allow time for the DNs to implement the change and give Shippers sufficient notice of charges ahead of 1 April, the normal date for changes to Transportation Changes in accordance with the DN Licences, such that the revised structure can be reflected in prices offered to customers.

In their respective responses, several parties supported one or more of the above suggested timescales for implementation, with some commenting that the options gave sufficient time for shippers to adjust their processes to the new charging calculation process. Additional suggestions put forward in responses ranged from asap, to no earlier than 2013, to provision of a 12 month lead time making April 2013 the earliest feasible date or finally, 12 clear months before the 1 February on which the new charges would be published for the first time.

7 The Case for Change

None in addition to those identified above.

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8 Legal Text

Proposer's Suggested Text

Amend section 3 of UNC TPD Section Y, PART B – DN TRANSPORTATION CHARGING METHODOLOGY, The Gas Distribution Transportation Charging Methodology to read as follows:

3. Split of revenue recovery between LDZ System Capacity and Commodity Charges

For Smaller Supply Points, the capacity element of the LDZ System charges is targeted to recover 50%, and the commodity element of the LDZ System charges is targeted to recover 50%, of the revenue from the LDZ system charges. This split is based on an assessment of the extent to which LDZ System associated costs are related to throughput or to system capacity. The 50:50 split applies to all the DNs.

For Larger Supply Points, the capacity element of the LDZ System charges is targeted to recover 95%, and the commodity element of the LDZ System charges is targeted to recover 5%, of the revenue from the LDZ system charges. This split is based on an assessment of the extent to which LDZ System associated costs are related to throughput or to system capacity. The 95:5 split applies to all the DNs.

Draft Text Provided by National Grid Distribution

UNIFORM NETWORK CODE – TRANSPORTATION PRINCIPAL DOCUMENT

SECTION Y – CHARGING METHODOLOGIES

PART B – DN TRANSPORTATION CHARGING METHODOLOGY

The Gas Distribution Transportation Charging Methodology

Amend section 3 of UNC TPD Section Y, Part B – DN Transportation Charging Methodology as follows:

3. Split of revenue recovery between LDZ System Capacity and Commodity Charges

In respect of Larger Supply Points the capacity element of the LDZ System charges is targeted to recover 95%, and the commodity element of the LDZ System charges is targeted to recover 5%, of the revenue from the LDZ system charges.

In respect of Smaller Supply Points the capacity element of the LDZ System charges is targeted to recover 50%, and the commodity element of the LDZ System charges is targeted to recover 50%, of the revenue from the LDZ system charges.

In respect of Larger Supply Points the above apportionment is based on an assessment of the extent to which LDZ System associated costs are related to throughput or to system capacity.

The apportionments described above apply to all the Distribution Networks.

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9 Consultation Responses

Representations were received from the following parties:

Respondent	
Company/Organisation Name	Support Implementation or not?
Corona Energy	Not in support
EDF Energy	Not in support
E.ON UK	Not in support
First Utility	Support
National Grid Distribution	Not in support
Northern Gas Networks	Not in support
Opus Energy Ltd	Support
RWE npower	Support
Scotia Gas Networks	Not in support
SSE	Support
ScottishPower	Comments
Spark Gas Shipping Ltd	Support
Wales & West Utilities	Not in support

Of the 13 representations received 5 supported implementation, 1 provided comments and 7 were not in support.

Summary Comments

Corona Energy, whilst sympathetic to the concerns regarding cash flow that the proposer has raised in the modification, believes that this proposal will not solve the root cause of the problem, namely that shippers are unable to predict with any accuracy the future course of transportation charges and plan accordingly. They support any such development that removes this unpredictable volatility. Corona Energy has noted that there is a desire for stable and predictable transportation charges as part of the upcoming price control and believe that this would be the most appropriate route to achieving such an outcome.

EDF Energy believe that there is a lack of evidence to support the view that costs associated to gas throughput have varied sufficiently to justify a return to a 50:50 split or that the current charging structure creates a barrier to entry to the market. It goes on to add that with regard to the effect on volatility of prices, the commodity charge is a function of consumption, which is historically more volatile than the system offtake quantity (SOQ). Implementation of this proposal will increase the need for GDNs to adjust charges as a result of disparity between forecast and actual throughput. This volatility may be unfavourable for shippers with fixed price contracts for supply and reduced predictability of costs may deter competition and market entrants.

E.ON UK notes that volatility in charging is undesirable and leads to an increased need for risk management with associated costs. They believe that the negative impact of

this volatility outweighs any positive cash flow benefits that may result from a return to a 50:50 split.

First Utility believes that the proposal would ensure that larger players do not gain an unfair advantage due to their greater size and ability to subsidise the mismatch between costs and revenues over the summer months when gas usage is lower.

Northern Gas Networks is sympathetic with the issues raised about phasing of revenues and costs for suppliers. However, they argue that the changes made in DNPC03 to change the balance of capacity and commodity charges from 50:50 to 95:5 were made to ensure that the revenues of the DNs were cost reflective. In their view, no evidence has been provided as to whether this has changed in such a way that would lead the GDNs to seek to reverse these changes. They also believe that it is not appropriate to make changes to the charging methodology for only the SSP market without robust supporting evidence that this market sector differs enough to warrant having different charging methodologies.

Opus Energy believes that the current system constitutes a barrier to entry for new participants whilst they see that the proposal would better facilitate competition amongst the suppliers by lowering the barrier.

RWE npower believes that the proposal addresses cash flow issues and removes potential barriers to entry for new suppliers. Furthermore, they believe the proposal is easier to administer than proposal 0383 "Profiling payment of LDZ transportation charges" for which they have concerns that offering different payment terms for small suppliers can become difficult to track in the event of insolvency or takeovers by larger companies.

Scotia Gas Networks point out that the different capacity/commodity splits for SSPs and LSPs could lead to distortions in the proportions of revenue recovered from the SSPs and LSPs because of the greater impact which weather would have on the SSPs. For example, a period of unseasonably warm weather would lead to under-recovery from the SSPs, and this under-recovery would go into K which would then be recovered across all supply points in the following period. LSPs could therefore be paying revenue which originally was intended to be paid by SSPs. These distortions would have no cost-based justification.

SSE believes that the current transportation charging structure profiles charges that are largely not dependent on gas throughput and so the charges do not follow the profile of customer charging and moving to a 50:50 split would go some way to addressing the imbalance.

ScottishPower note that Ofgem previously agreed with the transporter's argument that a 95/5 split brings more stability to Transporter charging when compared to a 50/50 charging regime. This proposal would however align settlement cost with customer billing through a 50/50 approach to capacity/commodity charging but would potentially introduce the unintended consequence of less stable Transporter prices year on year. They believe that there are more appropriate alternatives currently being considered by the industry that will allow shippers, operating in all markets, to more closely align their AQs, and therefore costs to revenue, whilst still maintaining the potential stability provided by the 95/5 capacity/commodity split.

Spark Gas Shipping believe that the cash flow implications of having a charge which remains at the same level throughout the year, regardless of demand, are significant to a small supplier as they are unable to match revenue with costs over the summer period. As their customer base is 100% domestic this is especially true. Furthermore, their unique position as a supplier to tenanted properties makes the company even

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more vulnerable to cash flow difficulties as a large proportion of their portfolio may be unoccupied at any point in time, leading to zero revenue while they are still liable for full costs.

In its response, Wales & West Utilities point out that under the transporter licence the GDNs have an obligation to ensure that transportation charges are cost reflective and so by making the change to 95%/5% Capacity/Commodity the GDNs were ensuring that they complied with the Licence requirements. Additionally, they do not believe that the proposer or the Workgroup have identified any reasons, or provided any justification, for effectively reversing the decision taken following significant industry review in 2008.

10 Panel Discussions

Members noted that Ofgem held a concern that the modification needed further assessment in order to make the case for change. However, Members did not believe that significant additional analysis and information could be delivered by the Workgroup, and Members suggested that this may be best taken forward by an Ofgem Impact Assessment if this was considered necessary to support their decision. Some Panel Members also considered that it may be more productive to focus on developing Modification 0383 rather than returning to 0382.

The Chair summarised that the modification is seeking to change the basis of LDZ system charges for smaller supply points, such that the split between capacity and commodity charges is amended from 95:5 to 50:50. This would mean a greater proportion of transportation charges being due in the winter than in the summer. In the case of primarily SSP Suppliers with revenue that is also in line with consumption, the change would therefore better align costs and revenues across the year.

Panel Members recognised that the basis of the capacity:commodity split had been moved from 50:50 to 95:5 following extensive consultation, including an Ofgem Impact Assessment. This had been supported on the basis that the majority of LDZ system costs do not vary with throughput, such that a capacity dominated charging structure is consistent with a charging methodology that results in charges which reflect the costs incurred by the licensee in its transportation business. Panel Members therefore accepted that returning to a 50:50 basis would be less reflective of costs incurred by Transporters.

Members were divided on whether implementation would be expected to better facilitate effective competition. It was noted that part of the justification for moving to 95:5 was to increase certainty. DN revenue which is throughput dependent is less certain than capacity based income since throughput is more variable than capacity, being driven in particular by the weather conditions experienced. This leads to a greater likelihood of allowed and collected revenue diverging, with subsequent adjustments to price levels in future years – creating charge volatility. Predictable charges support the securing of effective competition since they allow parties to set prices with greater confidence – reducing the risk of operating in the market. However, some Members did not feel that a significant benefit had accrued in practice with charges remaining difficult to predict with any confidence. By contrast, implementing the modification would better align costs and revenues for existing small domestic Shippers and Suppliers, and potential new entrants. There was a risk at present that supply could be loss making in the Summer months, creating an incentive to avoid entering the market or growing a business in the summer months. There is also a cashflow effect that can significantly impair the ability of smaller participants to compete – with access to funds being a key issue for many small and new businesses. Implementation could therefore, be expected to facilitate the securing of competition.

Members held opposing views on whether the deleterious impacts on competition had been given insufficient weight when the decision to move to 95:5 had been taken, and hence whether implementation of Modification 0382 would or would not be expected to facilitate the securing of the relevant objectives.

With one vote cast in favour and nine votes against, Panel Members determined not to recommend that Modification 0382 should be implemented.

Implementation will impact the achievement of **Relevant Objectives a and c.**

The benefits against the Code Relevant Objectives	
Description of Relevant Objective	Identified impact
a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;	Negative
aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: (iii) no reserve price is applied, or (iv) that reserve price is set at a level - (II) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers;	
b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;	
c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers; and	Positive
d) that the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).	

11 Recommendations

Panel Recommendation

The Modification Panel recommend that Modification 0382 is not made..