

URGENT Modification Report
Delay of Licence and Effects on Capacity Incentives
Modification Reference Number 0540

Version 1.0

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.9.3.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because Transco anticipates revised SO incentives being implemented via revisions to its GT Licence with effect from 1 April 2002. However, these licence amendments will not be finalised before 1 April. It is anticipated that, once finalised, the Licence amendments will be applied retrospectively and take effect from 1 April. Urgent status was therefore sought for this proposal to ensure that new arrangements can be put into effect from 1 April 2002 through transitional arrangements in the Network Code. Ofgem has agreed that this Proposal be given urgent status to provide Transco and shippers with greater certainty about the transitional arrangements for Transco's obligations with regards to the treatment of unsold baseline capacity. If approved the transitional arrangements will take effect from 1 April 2002.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

Issued to Ofgem for decision on urgency	5 March 2002
Proposal agreed as urgent	7 March 2002
Proposal issued for consultation	8 March 2002
Close out for representations	20 March 2002
Final report to Ofgem	22 March 2002
Ofgem decision expected	28 March 2002

1. The Modification Proposal

It will be necessary to amend the Network Code so that the structure and parameters of the buy back incentive are consistent with Ofgem's Final Proposals for SO Incentive Schemes, which are expected to be reflected in Transco's GT Licence in due course. Not making a change would result in Transco being unable to receive revenues or face costs in accordance with Ofgem's proposed incentive schemes. It would also create uncertainty in so far as the current Code terms would prevail and these would provide different incentives to the intent of the SO Incentive Scheme final proposals. If SO Incentive Scheme proposals were then implemented through Licence amendments that are retrospective in nature, complex reconciliation arrangements may be necessary.

It is proposed that the Network Code is modified such that capacity management costs and any incremental sales revenue will be redistributed via capacity neutrality arrangements, as introduced in Modification Proposal 0488. An incentive will be introduced under which Transco's Capacity Incentive Performance Measure (CIPM) is the magnitude of the net cost, or revenue, of actual costs of capacity management and incremental sales revenue for a formula year compared to a value equivalent to that proposed by Ofgem in its final proposals. Where CIPM is equal to zero (i.e. actual net costs are equal to forecast and performance is neither superior or inferior) Transco will face no reward or penalty. Superior performance occurs when actual costs are lower than the forecast and inferior performance occurs when actual costs exceed those forecast.

The incentive parameters for the year April 2002 to March 2003 which it is proposed to incorporate within the Network Code are:

- a. Target - £35 million cost
- b. Cap - £30 million revenue to Transco
- c. Collar - £12.5 million cost to Transco
- d. Upside sharing factor - 50%
- e. Downside sharing factor - 35%

The incentive costs or revenues will be reflected in an SO Commodity Charge and, therefore, existing Billing arrangements associated with the payment or receipt of incentive revenues to or from Transco will cease.

2. Transco's Opinion

Transco supports this Modification Proposal, as it believes implementation of this Proposal is required to facilitate implementation of Ofgem's final proposals in respect of Transco's NTS System Operator incentive scheme. Implementation would enable Transco to operate under the incentive schemes that are expected to be implemented with effect from 1 April 2002. It will also ensure continuation of the existing capacity neutrality mechanism and ensure revenues from the buy-back incentive are reflected in the SO commodity charge.

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

This proposal was raised in anticipation of changes to be proposed by Ofgem through Licence amendments. These changes would facilitate compliance with the relevant objective contained within Standard Condition 9(1)(b), i.e. the efficient discharge, by Transco, of obligations under its GT Licence.

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

There are no such implications

b) development and capital cost and operating cost implications:

There are no such costs

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

Any additional System Operator costs incurred as a result of implementing this Proposal would be accounted for under the proposed internal cost incentive scheme, as set out in Ofgem's final proposals for System Operator incentives.

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

There are no such implications.

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

Transco does not believe there are any such consequences.

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

There are no development implications.

7. The implications of implementing the Modification Proposal for Users

The implementation of this proposal will result in all of the incentive parameters (i.e. Capacity Incentive Performance Measure, Cap/Collar and sharing factors) being changed from 1 April 2002. The incentive costs or revenues will be reflected in an SO Commodity Charge and, therefore, existing Billing arrangements associated with the payment or receipt of incentive revenues to or from Transco will cease.

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

There are no implications.

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

The anticipated licence amendments alluded to in this Modification Report are based on Transco's understanding of Ofgem's final proposals for Transco's SO incentives. The proposed licence amendments are to be the subject of a consultation under section 23 of the Gas Act 1986 and no assumptions can be made regarding the outcome of that process.

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

Advantages :

It will ensure that Transco complies with anticipated amendments to its GT Licence.

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

Transco received a total of eight representations to this proposal:

Scottish and Southern Energy Plc
Agip (UK) Ltd
British Gas Trading
Norsk Hydro (UK) Ltd
Powergen UK Plc
Innogy Plc
Shell Gas Direct
TotalFinaElf Gas and Power Ltd

Six respondents supported the Proposal in the current form

Two respondents did not support the Proposal.

Incentive Arrangements

Six respondents Innogy, Agip, SSE, Powergen, BGT, and Norsk Hydro were in general agreement to the approach Transco has undertaken in raising this Modification to reflect the proposed System Operator incentive arrangements from 1 April. Innogy commented that it is “sympathetic to Transco’s reasons for raising this modification (along with 0539, 0541 and 0542) so that the incentive arrangements from 1 April are more closely aligned with those that will be included in its new GT Licence”. British Gas Trading although reluctantly in support of the Modification comments that “BGT recognise that these Modifications are necessary due to the delay in implementation of the proposed amendments to Transco’s Transporter Licence to reflect the incentive regime for their System Operator function in the Price Control for April 2002 onwards”.

Norsk Hydro (UK) Limited supports modification 0540. “It is understood that the revised SO incentives are to take effect from 1 April 2002 and if Transco are to prevent detailed and complicated retrospective reconciliation, arrangements of this nature are necessary”. SSE comments that it “does not agree with Transco’s assertion that implementing this modification would ensure there would be no need for a reconciliation process when incentives are introduced via Licence changes that take effect retrospectively from 1 April 2002. SSE considers that until the Licence changes are finalised and agreed with Transco there is no guarantee that the SO incentive will be introduced as anticipated. Innogy also commented that there is still the risk of reconciliation depending upon the exact form of the Licence amendments finally implemented. SSE suggests that there “is also a need to consider the treatment of buy-back to manage maintenance or compressor failures and whether this should be ring-fenced from performance incentive”

Transco Response

Transco considers that Ofgem has indicated in published documents that the buy-back incentive arrangements should be dealt with in a manner consistent with this Modification Proposal. Transco believes that this Proposal will ensure that no reconciliation process will be necessary based on its understanding of Ofgem's final proposals for SO incentives. Transco does not understand from Ofgem's Final Proposals for the SO incentives that there is any intention for buy-backs used to manage maintenance or compressor failures to be treated differently.

Licence Process

Six respondents (Innogy, SSE, BGT, Norsk Hydro, Shell Gas Direct and TFEG&P) express concerns with the delay in the Licence amendments. Scottish and Southern Energy Plc comment "SSE wishes to record general dissatisfaction with the process relating to the introduction of the System Operator (SO) incentive scheme into Transco's Licence as part of its new price control. Normally we would expect Licence conditions to be finalised and agreed ahead of the new price control period. However, as a result of indefinite delays to the consultation on the proposed Licence conditions, this and other urgent modification proposals have been raised by Transco".

TotalFinaElf Gas and Power Ltd, Norsk Hydro (UK) and Innogy express concerns on commenting in this Modification Proposal as the Licence proposals have not been finalised and published.

Transco Response

Transco sympathises with Users' views concerning the delay in publication of proposed amendments to Transco's GT Licence. Transco believes, however, that Ofgem has indicated in published documents that the buy back incentive should be implemented in a manner consistent with this Modification Proposal. Ofgem has indicated that the GT Licence will be implemented with effect from 01 April 2002.

Timelines

Three shippers (Innogy, BGT, SSE) are particularly concerned about the timescales associated with this Proposal. Innogy is concerned that "there is significant risk that insufficient consideration is given" to this proposal. SSE is uncomfortable that Ofgem is not expected to make a decision until 28th March and is "concerned that this leaves shippers and other interested parties little time to amend their processes to take account of these potential changes".

Transco Response

Transco is sympathetic to Users' concerns about the short timescales for this Proposal and following further discussions with Ofgem it is Transco's belief that Ofgem intends to make a decision on this proposal as soon as possible.

Incentive Revenue / Cost Flows

Four respondents (SSE, Innogy, BGT and Shell Gas Direct) commented on revenue flows from the incentive schemes. Innogy comments, “ We remain concerned that there is still insufficient industry understanding of the revenue flows and interaction between the various SO incentive components and the relationship between Transco’s SO and TO roles. The precise definition and range of Transco’s trading role under the new incentive arrangements is also far from clear”. BGT stated that, “ We accept that it would not be appropriate to continue with the regime as currently drafted in Network Code, as this would not have been representative of the more commercial incentives which Transco will now be subject to”. SSE would welcome clarity on how it is envisaged that payments from and to Transco in relation to its performance under the incentive would be recovered.

Transco Response

If implemented the Proposal would be based on the same principles as Modification Proposal 0488. Capacity management costs and any incremental sales revenue will be redistributed via capacity neutrality arrangements. The proposed SO Commodity Charge reflects Transco’s predicted buy back incentive outcome for April 2002 to March 2003. At the year end Transco will assess its actual performance against the performance target to be set in its licence. That performance against a pre-set target is recovered through the SO Commodity Charge which has been estimated so that it can take effect from 1 April. Any deviations in actual performance will be subsequently reflected through further adjustments to the SO Commodity charge for the following year.

Future Implications

Two Shippers (Innogy and SSE) request clarity on the mechanism by which the process described in this Proposal will be removed from the Network Code once the Licence amendments are implemented. SSE suggests that, “one approach would be to use the mechanism in Modification Rule 8.10.1(b) to initiate further consultation on modification 0520 (removal of entry capacity incentives from the Network Code) once the licence consultation has been issued. Innogy is unclear as to “...how this suite of modifications fits with Modification proposals 0519 and 0520....”

Powergen supports Modification Proposals 0539 and 0540 but on a permanent rather than a transitional basis. It is Powergen’s view “that SO incentives should be defined the Network Code as there should be full industry as well as Ofgem supervision of incentive schemes both in electricity and gas markets. If the parameters of the incentive scheme go into the Licence it will be impossible for shippers to make changes if, for example, they are set too far in Transco’s favour”.

Transco Response

Transco recognises that the Network Code modification process provides Shippers with a formal route through which they can propose amendments to the Network Code. However, it should be noted that there are no proposals for Ofgem’s suggested entry capacity incentive scheme to be incorporated other than in Transco’s GT Licence, and the present Proposal relates only to the

anticipated entry capacity buy back incentive. If this Modification Proposal is implemented, Shippers would still be at liberty to make informal representations to Ofgem if they believe that it would be in the interests of the industry and consumers for Transco's incentives to be modified. It should also be noted that Ofgem's proposals envisage the parameters of the buy-back incentive schemes being set for two years initially and that wide consultation can be expected when proposals for subsequent years are developed.

Transco recognises that there may be proposals for further development of the entry capacity regime. However, Transco does not believe that migrating its NTS SO incentives into its GT Licence would prevent such development.

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

Implementation is not required to facilitate compliance with any such legislation.

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

Implementation is not required having regard to any proposed change in the methodology established under Standard Condition 4(5) of the statement furnished by Transco under Standard Condition 4(1) of the Licence.

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

There are no such works required.

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

Final Modification Report issued	22nd March 2002
Ofgem decision expected	28th March 2002
Implementation	1st April 2002

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that this proposal be implemented.

17. Restrictive Trade Practices Act

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

18. Transco's Proposal

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

19. Text

TRANSITION DOCUMENT, PART II

Add new paragraph 8.1.13 to read as follows:

"B2.13 With effect from 1st April 2002 and without prejudice to the continued application of paragraph 8.1.11 of this Part II in respect of preceding calendar months and the application of paragraph 8.1.12, Section B2.13 shall continue not to apply and the arrangements set out in paragraphs (1) to (8) (inclusive) shall apply pursuant to which Transco will pay or be paid certain amounts to or by relevant Users in respect of each Formula Year by reference to the amount by which the Actual Annual Capacity Amount differs from the Forecast Annual Capacity Amount (the "**Annual Capacity Incentive Arrangement**"):

- (1) for the purposes of the Annual Capacity Incentive Arrangement for each Formula Year:
 - (a) the "**Capacity Incentive Annual Performance Amount**" is the Actual Annual Capacity Amount less the Forecast Annual Capacity Amount;
 - (b) the "**Actual Annual Capacity Amount**" is Relevant Annual Capacity Costs less Relevant Annual Capacity Revenues;
 - (c) the "**Forecast Annual Capacity Amount**" is £35,000,000 of Relevant Annual Capacity Costs in excess of Relevant Capacity Revenues;
- (2) in relation to the Annual Capacity Incentive Arrangement, for any Formula Year, Transco's performance:
 - (a) is 'superior' where the Actual Annual Capacity Amount is less than the Forecast Annual Capacity Amount; and
 - (b) is 'inferior' where the Actual Annual Capacity Amount is greater than the Forecast Annual Capacity Amount;
- (3) for each Formula Year the "**Relevant Annual Capacity Incentive Amount**" is:
 - (a) where Transco's performance was superior, the amount determined as the lesser of:
 - (i) £30,000,000; and
 - (ii) $CIAPA * 0.5$;
 - (b) where Transco's performance was inferior, the amount determined as the lesser of:
 - (i) £12,500,000; and
 - (ii) $CIAPA * 0.35$; and
 - (c) where the Capacity Incentive Annual Performance Amount is zero, zero,

where CIAPA is the Capacity Incentive Annual Performance Amount;

- (4) for the purposes of calculating the Actual Annual Capacity Amount no account shall be taken of Relevant Capacity Costs incurred by Transco in the circumstances referred to in Section B2.13.4;
- (5) Having derived the Relevant Annual Capacity Incentive Amount pursuant to (3) above that sum, which may be a negative or positive number, shall be added to other revenues that Transco is entitled to recover in calculating the NTS Commodity Charge in accordance with the Transportation Statement
- (6) a "**Formula Year**" means the period from 1 April in any year to 31 March in the following year;
- (7) "**Relevant Annual Capacity Revenues**" means in respect of a Formula Year the sum of Relevant Capacity Revenues for each calendar month in such year; and
- (8) "**Relevant Annual Capacity Costs**" means in respect of a Formula Year the sum of Relevant Capacity Costs for each calendar month in such year."

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date:

Gas and Electricity Markets Authority Response:

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0540**, version **1.0** dated **25/03/2002**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:

Process Manager - Network Code
Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:
 - (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or
 - (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriateprovided that if the Authority does not so approve the Agreement then Clause 3 shall apply.
2. If the Authority does so approve this Agreement in accordance with the terms of the Order (whether such approval is actual or deemed by effluxion of time) any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.
3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, had it not been repealed, would apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) or 2(2)(b)(ii) of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.
4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.