

Modification Report
URGENT Modification Reference Number 0398
Revision to price payable for Monthly System Entry Capacity for May - September
2000
Version 2.0

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

1.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.

Pricing Consultation 53 proposed a number of options for the adjustment of transportation charges to compensate for the higher than anticipated revenues arising from the last round of entry capacity auctions. One option under consideration is the reduction of the prices which will actually be paid by successful bidders for Monthly System Entry Capacity (MSEC). This modification proposal proposes a mechanism to facilitate this reduction, and in view of the fact that changes may be required with effect from 1st May 2000 urgent procedures were required.

2.Procedures Followed:

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

Issued to Ofgem for decision on urgency 26 April 2000
Proposal agreed as Urgent 26 April 2000
Proposal issued for consultation 26 April 2000
Close out for Representations 27 April 2000
Final Report to Ofgem 28 April 2000
Ofgem decision expected 28 April 2000

3.The Modification Proposal:

The Network Code specifies that a successful bidder will pay their bid price for MSEC. This modification proposal proposes that, as a transitional measure for the period May - September 2000, the price actually paid by successful bidders is multiplied by a "revenue adjustment factor" set out in the transportation statement. The factor to be applied will be calculated in accordance with Pricing Consultation 53. For example, should the outcome of that consultation be that no change be made to the price payable, the factor would be one. The proposal also ensures that Transco's incentive is unaffected by retaining the use of prices bid for the calculation of the Transco Monthly Amount.

4. Transco's opinion:

Transco supports this proposal. If as a result of Pricing Consultation 53 it is agreed that a reduction should be made to the price paid for MSEC, this proposal will enable such a reduction to be made.

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

If implemented, this modification proposal would facilitate a reduction in the prices paid for MSEC. Any such reduction in price could promote more active trading of the product which could lead to more efficient operation of the system and better facilitate competition between shippers.

6. The implications for Transco of implementing the Modification Proposal, including:

a) implications for the operation of the System:

The implementation of this proposal would have no significant impact upon the operation of the System.

b) development and capital cost and operating cost implications:

There are no development, capital or operating cost implications as a result of implementing this Proposal.

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:

Not applicable.

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

No such consequences are envisaged.

7. 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:

It is not anticipated that there will be a change to the level of contractual risk to Transco as a consequence of this proposal.

8. **The development implications and other implications for computer systems of Transco and related computer systems of Users:**

No development implications for computer systems of Transco and the related computer systems of Users are anticipated.

9. **The implications of implementing the Modification Proposal for Users:**

Users will be able to pay a price for MSEC which is lower than the bid price at which they were allocated MSEC.

However, Users may have traded both entry capacity and NBP gas on the basis of the prices bid in the MSEC auction. If a revenue adjustment factor of less than one is applied, the actual price paid for MSEC would be less than that assumed when trades were entered into.

10. **The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Storage Operators suppliers, producers and, any Non-Network Code Party:**

If a revenue adjustment factor of less than one is applied, Users will be able to pay a price for MSEC which is lower than the bid price at which they were allocated MSEC. Such a reduction in MSEC prices may compensate some of the perceived market effects created by the higher than expected prices originally bid.

11. **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:**

No significant consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party are anticipated as a result of the implementation of this proposal.

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

Advantages:

- This proposal will enable Users who were successful in obtaining MSEC in the recent auctions to pay a price which is lower than their bid price.

- A reduction in the price paid for MSEC would ensure that transportation revenue recovered from MSEC would be closer to the level that had been anticipated from the sale of MSEC over the period in question.

Disadvantages:

- An ex post change in the payment rules for the MSEC auction may be viewed as undermining the outcome of the auction. It may be argued that some bidders who were not successful because their bid was too low would have bid higher had they known that the price paid would subsequently be reduced.

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

Four respondents (Marathon, Corus, National Power, Exxon Mobil) support the proposal without reservation.

One respondent, Scottish and Southern Energy (SSE), supports the proposal but expresses concern over the limited time available for comment and stresses the need for the decision on any pricing changes to be circulated through numerous media.

Two respondents, Alliance Gas (AGS) and TXU Europe Energy Trading (TXU), support the application of a Revenue Adjustment Factor but do not support the continued use of bid price, rather that price paid, for calculation of Transco's incentive. One respondent, BP Amoco (BPA), supports the proposal but seeks clarification over the application of Transco's incentive. One respondent, Shell Gas Direct (SGD), supports the principle of price adjustment but is unclear as to whether the proposal as it stands is appropriate and does not support the use of bid price for incentive calculation.

Three respondents, British Gas Trading (BGT), Scottish Power (SP) and Yorkshire Energy (YE), do not support the proposal.

Notice Period and Communication of outcome

SSE expresses dissatisfaction with the short period afforded for consultation and believes that this modification could have been raised in a more timely fashion. SSE goes on to say that in view of the limited time available Transco should use all reasonable means to communicate the outcome of the proposal, such as the Modification mailing list, the RGTA e-mail list and the Shipper Information Service.

Use of Revenue Adjustment Factors

BGT argues that it is not appropriate to introduce the concept of a factor into the Network Code on a provisional basis and that a decision should be made on Pricing Consultation 53 before any modifications are raised. It believes that this amounts to a retrospective change to the Network Code and undermines the basis upon which commercial decisions have been made. This point is supported by SP and YE who

both state that a retrospective change to the prices paid makes a mockery of the auction process. SP suggests that this modification could affect the outcome of Pricing Consultation 53 and that Ofgem should veto Pricing Consultation 53. SP also says that Transco could face “significant legal challenge” if a reduction in the price paid for MSEC is facilitated by this proposal.

YE seeks an explanation from Transco as to why it is now in favour of such an approach when it had initially ¹ ² favoured a reduction in NTS commodity rate. Whilst supporting the principle of the proposal, SGD questions whether the proposal needs to reflect any adjustments that need to be made to other prices, such as the Daily System Entry Capacity (DSEC) price, as a result of this proposal.

Transco Incentive

BGT suggests that Transco’s attempt to retain all of the additional revenue resulting from Modification 0382 is unreasonable and that the suggestion that Transco should retain the “huge revenue windfall” is beyond belief. TXU argues that retention of the bid price as the basis of calculating the incentive amount will result in significantly more incentive revenue for Transco than was envisaged under Modification 0382. AGS argues that the stated target of Modification 0382 was £800,000 and that it seems inconsistent to allow Transco to gain £2.5 million as this would constitute more than 20% of the revenue received if bids are reduced. BPA requests clarity over how Transco’s incentive position will be maintained. SGD does not understand why Transco believes that the use of the bid price is consistent with Transco’s relevant objectives, and confirmed that it did not support Modification 0382.

Transco Response:

Notice Period and Communication of outcome

Transco recognises that a limited period of time has been allowed for consultation. However, this Modification Proposal is an enabling measure and does not in itself mean that the prices paid in the auction will be less than the bid price. As such, Transco is of the opinion that to have raised this proposal prior to the conclusion of consultation (and subsequent discussion as to the outcome) of Pricing Consultation 53 may have prejudiced responses to that consultation. It should also be noted that the nature of the change this proposal facilitates has been the subject of extensive consultation (including two industry meetings) through Pricing Consultation 53.

Transco is aware of the need to ensure that relevant industry participants are informed of the outcome of the proposed changes and will use all reasonable means of communication.

Use of Revenue Adjustment Factors

Transco does not agree that it is inappropriate to introduce a provisional measure to the Network Code. A number of shippers, both privately and in industry meetings, have argued that prompt action is required to address the higher than expected auction revenue. If implemented, this proposal would facilitate this. One of the options

discussed within Pricing Consultation 53 is to reduce the price paid for MSEC and the timing of Pricing Consultation 53 allows for any changes to be implemented on 1st May 2000. Had this proposal been raised once the outcome of Pricing Consultation 53 is known, it would not be possible to progress the proposal in time for a 1 May 2000 implementation. Any reduction in charges would then be delayed until at least 1 June 2000. In view of this, Transco believes it is appropriate to have raised this proposal to enable one of the options being considered in Pricing Consultation 53.

Transco is aware of the view that any retrospective change to the price paid undermines the principle of the auction. However, Transco believes that such views have been adequately expressed, and responded to, within responses to Pricing Consultation 53. This Modification Proposal facilitates a reduction in the price paid but the question of whether a reduction does take place is the subject of Pricing Consultation 53. It is, however, worth noting that the majority of respondents to Pricing Consultation 53 supported a reduction in the price to be paid as a means to address over recovery.

In response to YE's query¹ as to why Transco had changed its view, Transco would like to point out that its preference for an adjustment to NTS commodity in Pricing Consultation 53 was in respect of a possible future correction method for over/under recovery. Transco did not express a single preference for addressing the immediate situation, and invited views as to whether a reduction of either NTS commodity or the price actually paid for MSEC would be appropriate.

Transco recognises that a reduction in the price actually paid for MSEC could have a "knock on" effect to other prices such as the reserve price for DSEC. However, as the reserve prices for all capacity services are not the subject of the Network Code they have not been considered in this Modification Proposal. Any reduction in such reserve prices would be reflected in the Transportation Statement.

Transco Incentive

Transco does not agree that the amount calculated under the incentive mechanism is in excess of that contemplated by the method. Transco indicated that, in the absence of an increase in available MSEC, if behavior during the summer months were similar to that of the period October 1999 to March 2000 then the summer incentive revenue would be approx. £800,000. This was not a target figure. The amount of revenue Transco receives from the application of the incentive is, in any case, subject to a cap. Given the fact that the cap was agreed by the industry it seems strange that a sum of money which could take Transco up to this cap for a part of the year should be seen as a huge revenue windfall.

It should also be noted that incentive revenue Transco actually receives could be reduced significantly as a result of buy back costs over the summer. The rationale for Modification 0382 was that the increased quantity of MSEC would reduce the amount of DSEC Transco could sell and increase its potential exposure to buy back costs. The calculation of an incentive value from the prices bid in the auction is intended to represent the prices which could have been paid for DSEC and the prices which could be commanded for buy back. This re-balancing of the incentive was to ensure that it

retained its effect in promoting behaviour by Transco which ensured the efficient and economic operation of the system. Any reduction in the amount actually paid is a result of the potential for over recovery in terms of the price control. The fact that shippers were willing to bid, and presumable pay, higher prices in the first instance, suggests that they would also have been prepared to pay such a price on a daily basis, and that the cost of buy back could be equally high. In view of this, Transco is of the opinion that it remains appropriate to use the bid price as the basis for calculation of the incentive amount and that this will maintain the efficiency of the incentive.

14. 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 safety or other legislation.

15. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 3(5) of the statement; furnished by Transco under Standard Condition 3(1) of the Licence:

One of the options proposed within Pricing Consultation 53 is a reduction in the actual price paid for MSEC by successful bidders in the recent round of auctions. As the price that is paid is set out in the Network Code, this Modification Proposal is required to facilitate the application of any adjustment factor set out in the Transportation Statement.

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

If implemented, Transco would apply revenue adjustment factors to successful bids for MSEC with effect from 1st May 2000.

17. Proposed implementation timetable (inc timetable for any necessary information systems changes):

Shippers would be notified of the Revenue Adjustment Factors which would apply on the 28th April. Revenue Adjustment Factors would then be applied to the prices bid by shippers in respect of MSEC from 1st May 2000.

18. Recommendation concerning implementation of the Modification Proposal:

Transco recommends that this Modification Proposal is implemented and seeks direction from the Director General in accordance with this recommendation.

19. 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.

20. Transco's Proposal:

This Modification Report contains Transco's proposal to modify the Network Code and Transco now seeks direction agreement from the Director General in accordance with this report.

21. Text:

Transitional Document, Part II, Paragraph 8,

Renumber paragraph 8.1.4 as paragraph 8.1.5

Add new paragraph 8.1.4 as follows :

“8.1.4 B2.9.3 (1) In respect of the period from 1st May - 30th September 2000 for the purposes of paragraph B2.9.3(i) the Applicable Daily Rate, in respect of the Monthly System Entry Capacity applied for pursuant to the invitation under paragraph B2.3, shall be the rate (for the relevant calendar month) determined following the relevant invitation dated in accordance with paragraph B2.3 multiplied by the relevant revenue adjustment factor.

(2) For each calendar month referred to in paragraph (1), the “relevant revenue adjustment factor” is the factor of that name applying in respect of each such calendar month as set out in the Transportation Statement.”

8.1.6 B2.11.3 In respect of the period from 1st May - 30th September 2000 for the purposes of paragraph B2.11.3(e) :

A is the aggregate amount of System Entry Capacity Charges which would have been paid by Users in respect of Monthly System Entry Capacity allocated for the calendar month in accordance with paragraph B2.3 had the provisions of Transitional Document Part II section 8.1.5 B2.9.3 not applied.

B is the aggregate amount of System Entry Capacity Charges which would have been paid by Users in respect of Monthly System Entry Capacity allocated for the calendar month in accordance with paragraph B2.4 had the provisions of Transitional Document Part II section 8.1.5 B2.9.3 not applied.”

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Director General of Gas Supply Response:

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0398**, version **2.0** dated **28/04/2000**) be made as a modification to the Network Code.

Signed for and on behalf of the Director General of Gas Supply.

Signature:

The Network Code is hereby modified, with effect from _____, in accordance with the proposal as set out in this Modification Report, version **2.0**

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 Director General of Gas Supply ("the Director") 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 Director 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 appropriate

provided that if the Director does not so approve the Agreement then Clause 3 shall apply.

2. If the Director 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 Director does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavors 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 Director 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 Director 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.