Modification Report
URGENT Modification Reference Number 0209
Use of Top Up to avoid excessive flexibility prices

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.12.4.

1. Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.2(a) Ofgas has agreed that this Modification Proposal should be treated as Urgent because of the views held by a number of shippers that a change is required this winter.

2. Procedures Followed:

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

13th February 1998	Ofgas agree proposal as urgent
20th February 1998	Close out of shipper representations 5.00 pm
24th February 1998	Modification Report to Ofgas
27th February 1998	Ofgas decision expected

3. The Modification Proposal:

Enron have raised Modification Proposal 0209 to vary the level of N dependent on the level of demand. Their stated aim is to moderate system prices where these are not solely dependent on supply demand conditions. Enron claim that a further benefit may be reduced Top-Up costs.

4. Transco's opinion:

Transco oppose this proposal on the grounds that it would seriously undermine future incentives on shippers to ensure that they have sufficient gas supplies to meet their firm customers' demand requirements. The suggestion that Top-Up should be used to moderate market prices, totally ignores the security of supply role for which current levels of Top-Up have been booked.

Top-Up has been booked to meet security of supply requirements where shippers gas in store is insufficient to meet their 1 in 20 / 1 in 50 firm demand requirements. It is bid into the flexibility mechanism at a high price to maintain incentives on shippers to obtain sufficient peak gas services. Any price spike implies high demand conditions, or inefficient market mechanisms in the flexibility mechanism, a situation which could be exacerbated in the event of supply failure. The latter is a further risk which shippers need to consider in light of possible system prices which in the most severe case would be Top-Up prices.

Enron's proposal would treat the symptoms of the perceived "failure of the market" by moderating "artificial" prices but does nothing to address any fundamental cause. Any weakness in the current market could be partly attributed to either inadequate or ill-understood incentives. Reducing the incentives further could allow those who mis-read conditions to benefit at the expense of those who took appropriate mitigating action and consequently could be construed as discriminatory. More seriously such a change could give an expectation that shippers do not need to mitigate such risk in the future. While this may be seen as a benefit to some parties in the short term, it would undermine any future incentive based regime or any market based balancing mechanism.

Clearly, the proposal to vary the value of N depending on the level of demand would limit the incentive for shippers to obtain peak services in the future. Hence the Top-up requirement for next year (if still in place) would increase. This is particularly the case for relatively low values of N. Low values of N could also have the knock-on effect of reduced offshore reliability / security and reduce the incentive for the development of competing storage facilities to BG Storage and high swing beach supplies. This proposal has no credence if Top-Up is not booked as there would be no Top-Up bids to adjust. The market would not be artificially capped at a very low price as in Enron's proposal and would be able to operate as originally intended.

Enron's example of prices is for LNG at the most expensive facility (Dynevor). Rough Top-up prices would be appreciably less, for example with N = 1, the price would only be £0.42/therm, and at N = 10 £2.62/therm. Under these conditions particularly for N = 1 there could be considerable use of a Rough service to support firm demand and possibly interruptibles at a low price. This in turn would have significant implications in reducing the security levels well below the monitors at relatively low levels of demand. Consequently, following acceptance of a Top-Up bid, the Top-Up manager would be required to buy back the gas at the prevailing market price. In the case of LNG particularly, physical injection rates would require this repurchase to take place immediately, possibly at a higher price and hence with a detrimental effect to Top-Up costs. Where injection was not possible, security of supply to firm customers would be jeopardised, possibly as a result of supplying interruptibles.

Enron also suggest that Top-Up should be made available to support supply failure at levels of demand below peak. Transco consider this to be wholly inappropriate given that current levels of Top-Up were booked only to meet security of supply requirements and would be insufficient in the event that demand subsequently increased. Transco would argue that shippers are responsible for making good their own supply shortfall and that the market should be encouraged to ensure that price is dictated by supply/demand conditions and not impaired by artificial dampening using Top-Up.

In Transco's opinion, Enron's proposal raises a number of issues which make it inappropriate to adopt in the current regime and consequently it can only be considered as part of the Ofgas consultation on Top-Up and the Review of the Energy Balancing regime.

5. <u>Extent to which the proposed modification would better facilitate the relevant objectives:</u>

In the short term the Modifications might create a better and more efficient system, however by undermining future incentives the Modification may give rise to higher costs and increased inefficiency in the longer term.

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

a) **implications for the operation of the System and any BG Storage Facility:**

Top-Up bids may be accepted more readily on the flexibility mechanism and hence BG Storage facilities may be used more frequently in place of beach gas.

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

Additional operating costs would be incurred through changing Top Up bids according to the level of demand. If Top Up is used it may have to be repurchased at the market price prevailing at the time which may be significantly greater than its original purchase price.

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:**

Additional Top-Up costs would be recovered via Top-Up neutrality. Other costs are included within the current formula provisions.

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

Transco is not aware of any impact on price regulation.

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:**

The contractual risks to Transco arises from the implications of changing the commercial regime within the winter period and the detrimental impact on security of supply. In addition, it undermines future incentives on the community to meet customers' peak demand requirements, as there is always the potential to change the contractual obligations retrospectively.

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

Transco is not aware of any implications for Transco or Shipper systems.

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

Artificially capping the flexibility mechanism may lead to less extreme cashout prices. However, these would still arise where large volumes of gas were required by the system, with a subsequent risk of even higher prices if Top-Up was over-utilised. Shippers would have to revise their flexibility bidding strategies daily, based on demand levels. Shippers may not be able to recover as readily the costs invested in stored gas to meet peak demand or may see less benefit than anticipated from booked storage services.

It also would change the commercial positions of some organisations who have already procured storage services.

10. The implications of implementing the Modification Proposal for terminal operators, suppliers, producers and, any Non-Network Code Party:

The modification would place greater reliance on Top-Up to meet demand below the peak levels for which it has been purchased and hence may impact on the sources from which shippers normally choose to source peak gas.

11. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each Relevant Shipper and Non-Network Code Party of implementing the Modification Proposal:

The use of reduced incentives at lower levels of demand would prevent Transco from meeting its obligation to provide sufficient incentive for suppliers to meet their domestic security standard.

Implementation could also put BG plc in breach of Standard Condition 11 (non-discrimination) of its PGT Licence.

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

Advantages - those shippers who booked insufficient storage to meet firm demand or to cover the risk of supply loss will be less exposed to price risk in the short term.

Disadvantages - future incentives will be severely undermined both with respect to provision of peak services and participation in the flexibility mechanism
- the flexibility mechanism will be effectively capped, inhibiting the development of a more efficient market.

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

13 representations were received from shippers, 8 of them opposed to the modification proposal. Most of the issues raised are addressed in section 4 of this report.

One point not covered relates to market constraints to inhibit very low prices for system sell bids. Transco is of the opinion that this should also form part of the Energy Balancing and/or Top-Up reviews.

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

Implementation is not required for these purposes.

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:

Standard Condition 3(5) requires the licensee to establish a methodology for the determination of transportation prices, and 3(1) requires the licensee to furnish the Director with a statement of transportation arrangements and prices, and the methods and principles by which prices are determined. Neither clause is directly relevant.

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

To be agreed if the modification is approved.

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

It is not proposed that this modification is implemented.

18. Recommendation concerning implementation of the Modification Proposal:

Transco recommends that this proposal should not be implemented.

19. Transco's Proposal:

This Modification Report contains Transco's proposal that this Modification is not implemented.

20. Text provided pursuant to Rule 9:

Transco does not consider it appropriate to provide legal text as it does not believe the Modification should be made.

Signed for and on behalf of Transco.

Signature:

John Lockett
Manager, Network Code
Date: 24. 2. 98

<u>Director General of Gas Supply Response</u>:

I hereby accept Transco's recommendation contained in this report that this Modification should not be made to the Network Code.

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

Signature:

Kyran Hanks
Director of Transportation Regulation
Date: