

Modification Report
Modification Reference Number 210

This Modification Report is made pursuant to Rule 8.12 of the Modification Rules and follows the format required under Rule 8.12.4.

1. The Modification Proposal:

This modification relates to section P of the Network Code.

Summary

In October 1997 Transco advised shippers that 1997/8 Top-Up costs were estimated as £16.81 million, after a reduction relating to an increase in the assumed beach gas availability relating to "J-block" gas.

Such costs are recovered via "smearing" in four monthly instalments, in invoices relating to the December 1997 and January, February and March 1998 energy balancing invoices.

On 16 January 1998 Transco advised shippers that they had incorrectly assumed that Transco would receive a full rebate of Rough storage charges following a reduction in the Top-Up booking at that facility, that BG Storage would be charging for the firm Rough service used up to the date of notification by the Top-Up Manager that the service requirements had been reduced and that the Top-Up costs were therefore increased to £28.5 million.

British Gas Trading argue that the proposed outcome is clearly not as the community were led to believe by Transco, as was originally intended when the network code rules were written or as Transco believed applied as at October 1997. Moreover, leaving the rules as currently interpreted places an incentive on BG plc to overstate requirements such that BG Storage can generate income, at the expense of shippers.

Hence British Gas Trading submitted Modification 210.

It proposes -

a) the Top-Up Manager should be required to delay bookings of storage to the latest practicable dates consistent with achieving the requirements for gas in store by the end of summer or beginning of winter by injection and/or purchase

b) when the Top-Up Manager recalculates Top-Up requirements in accordance with the provisions of the Network Code and these requirements have reduced, as well as the credits deriving from the sale of surplus gas there should be a full repayment of storage costs associated with the volume relinquished.

Moreover British Gas Trading proposes that these principles should apply to the 1997/8 Top-Up requirements, and that BG plc should reimburse to the shipping community the £11.7 million "claimed" in January.

British Gas Trading does not accept that according to the Network Code Transco are entitled to act as they have: having received a letter from a BG Director and bearing in mind the intention of the parties when the Code was being developed, shippers would reasonably budget on the basis advised on 6 October 1997, and British Gas Trading therefore contends that Transco should make the refunds.

The Network Code Modification Panel referred the proposal to a combined meeting of the Energy Balancing and Planning & Security Workstreams. This meeting was held on 12 March 1998.

The Shippers at the meeting fully supported the proposal, with only Transco objecting.

Background

On 21 May 1997, Transco published initial estimates of the 1997/8 Top-Up requirements, namely 317 GWh/d of deliverability (including 237 GWh/d Rough) and 5644 GWh of space; the associated cost estimates were £65 million, of which £59 million related to Rough. The estimated beach deliverability was 3705 GWh/d.

The next estimates were dated 10 July 1997. Beach deliverability was unchanged, but a further 80 GWh/d of Rough firm storage deliverability had been booked by shippers. So the revised Top-Up volume estimates were 237 GWh/d of deliverability (including 157 GWh/d Rough) and 3371 GWh of space; and the costs were estimated as £45 million (including £39 million for Rough services) - in effect, the shipper(s) concerned took over some of the Top-Up Manager's booking of Rough, and BG Storage's revenues were unchanged.

Transco's next (and final) estimates were dated 6 October 1997. The main change was that assumed beach gas deliverability had increased by 110 GWh/d from 3705 GWh/d to 3815 GWh/d; and the Top-Up estimates had reduced to 127 GWh/d of deliverability (including 47 GWh/d Rough) and 1110 GWh of space.

Transco's latest estimate of costs at this date was £16.81 million.

Then on 16 January 1998 shippers were notified by Transco that an incorrect assumption had been made by Transco with regard to the rebate of Rough storage charges following a reduction in the Top-Up booking at that facility. After detailed discussions between and BG Storage and legal interpretation of the Network Code text by both Transco and BG Storage, BG Storage were charging Transco for the firm Rough service used up to the date of notification by the Top-Up Manager that the service requirements had been reduced (23rd September 1997). The net result was a reduction in the rebate from £27.7 million to £16 million. This resulted in a revised estimate of Top-Up costs at that time of £28.5 million.

Subsequent correspondence from Transco on 26 January 1998 provided an update to the figure for the 16th January. This stated that the revised gross costs were £30.4

million and that there would be a rebate related to profit on gas sales estimated at £2.8 million.

The relevant Network Code Rules

Section P of the Network Code covers the relevant rules.

In essence, Transco use their best estimates of demands and beach gas availability, based on all evidence available to them, including limited information provided by shippers.

They assume that any deficits in gas supply on the 1-in-20 peak day and under 1-in-50 severe winter conditions must be covered by storage services. To the extent that shippers' bookings do not cover the deficits, the Top-Up Manager will make bookings of BG Storage services and take appropriate steps to procure and inject gas to cover the deficits. From 1998/9 part of this requirement will be offered to other parties via competitive tender with a view to all requirements being obtained via tender.

The Top-Up Manager is required to review the estimates if demand or beach availability estimates alter (up to 1 October in any Storage Year).

There may be economic incentives such that shippers delay storage bookings, for example linked with uncertainty over market share. In such cases BG Storage must "transfer" bookings from the Top-Up Manager to the shipper: BG Storage's income remains intact but the community benefits from lower Top-Up costs and "smearing".

There is no requirement in the Code for BG Storage to accept a reduction in the Top-Up Manager's booking if the Top-Up requirements alter as a result of changes in demand estimates or beach gas availability estimates.

There is a general obligation (para 2.4.1(b)(ii)) that the Top-Up Manager should "select the Storage Facilities" in which it stores Top-Up "with a view to the lowest aggregate Storage Charges". There is no explicit obligation to (for example) delay or stagger bookings where there may be uncertainty in the demand or supply estimates with a view to avoiding costs which with the advantage of later information may not be necessary. There is also no provision for the Top-Up Manager to hold an option on firm storage deliverability in the event that the requirement rises.

There are no rules for relinquishing space or deliverability other than in respect of a new (late) storage booking.

1997/8 Issues & Conclusions

British Gas Trading accepts that all of the Top-Up Manager's and Transco's actions in respect of the 1997/8 Top-Up requirements are in line with the existing Code rules, except in that Transco provided in October 1997 an estimate of costs (£16.81 million) which incorrectly assumed that Transco would receive a full rebate of Rough storage

charges following a reduction in the Top-Up requirements at that facility relating to an increase in the assumed beach gas availability relating to "J-block" gas.

BG Storage have declined to provide such a rebate. They have charged for the firm Rough service used up to the date of notification by the Top-Up Manager that the service requirements had been reduced but have cancelled the booking from that date with no refund in respect of the earlier period.

With hindsight:-

- it was always evident that there was considerable uncertainty as to the availability or otherwise of J-block gas in particular (it was subject to litigation). It would have therefore been imprudent of the Top-Up Manager to assume that the field was going to be available

- the uncertainty affected the Top-Up requirements for Rough services only

- there would have been no commercial risk in delaying the Rough booking since there was no problem if the services were sold out (as this would have eliminated the requirement for Top-Up), the Top-Up Manager has however stated that there would have been a risk to security of supply if the service became unavailable due to lack of interest in the service

- the key timing factor was the time to inject such gas as might be needed, in fact the entire Rough deliverability booking could reasonably have been delayed at least to 1st September, which would have meant no initial payments to BG Storage and hence obviated the problems of unnecessary cost in relation to Rough, albeit at the expense of moderate interest charges for late bookings. However there remains the concern stated by the Top-Up Manager regarding security of supply

Delaying bookings to the latest date consistent with injection requirements is recommended as a basic strategy for the Top-Up Manager, taking account of the risks that the required service may not be available. The commercial impact with regard to future tender arrangements will also need evaluation.

Hence one key conclusion/recommendation is that the Top-Up Manager should be required to delay bookings of storage to the latest practicable dates consistent with achieving the requirements for gas in store by injection and/or purchase.

A second issue arises because Transco is cash neutral with regard to the provision of Top-Up. The recent Ofgas Consultation Paper on Top-Up issues observes:-

- "Effectively Top-Up provides Transco with a means of increasing security at no cost to itself. Transco may therefore have an incentive to overestimate the requirement for Top-Up"

- "An over-estimation of the Top-Up requirement by Transco could potentially benefit BG Storage"

- "Such incentives may encourage the Top-Up manager to take a conservative view of the availability of peak supply".

British Gas Trading is pleased to emphasise that it is aware of no evidence either that the Top-Up Manager or BG plc took a knowingly conservative view or that the various estimates were biased for any reason.

However the Ofgas paper also says -

- "In 1996/7, for example, the Top-Up manager underestimated beach supply by more than the calculated Top-Up requirement, suggesting that with hindsight Top-Up was not required"

- and "There would be no requirement for Top-Up in 1997/8 either but for the so-called "V factor"

It is certainly the case that overestimation of Top-Up (however justifiable) results in income for BG plc (BG Storage specifically) and costs for the shipping community that are unnecessary. Hence leaving the rules as currently interpreted can be argued to place an incentive on BG plc to overstate requirements such that BG Storage can generate income, at the expense of shippers.

Primarily to avoid any "incentives" such as are described above, **British Gas Trading's second main recommendation is that when the Top-Up Manager recalculates Top-Up requirements in accordance with the provisions of the Network Code and these requirements have reduced, as well as the credits deriving from the sale of surplus gas there should be a full repayment of storage costs associated with the volume relinquished.**

In respect of 1997/8 British Gas Trading argues that such rules would at least have saved the community the £11.7 million referred to in the 16 January letter.

Moreover the proposed outcome is clearly not as the community were led to believe by Transco, as was originally intended when the network code rules were written or (evidently) as Transco believed applied.

Therefore British Gas Trading proposes that these principles should apply to the 1997/8 Top-Up requirements, and that BG plc should reimburse to the shipping community the £11.7 million "claimed" in January.

British Gas Trading accepts that according to the Network Code Transco are entitled to act as they have; but having received a letter from a BG Director, shippers would reasonably budget on the basis advised on 6 October 1997, and British Gas Trading therefore contends that Transco should make the refunds.

Hence British Gas Trading recommends that the modifications apply to the 1997/8 Storage Year and to 1997/8 Top-Up requirements.

British Gas Trading offers no view as to whether the refund should necessarily come from BG Storage, Transco or BG plc.

British Gas Trading observes that in a period where BG Storage has reputedly exceeded its revenue cap for the year by a similar amount it could be helpful if Ofgas would accept that any refund emerging (even if on an "ex gratia" basis) is regarded as adjusting the end-year level of over- or under- recovery, whether from BG Storage or Transco.

2. Transco's opinion:

It is Transco's opinion that this modification should not be approved.

In response to the three proposals submitted by British Gas Trading Transco has the following comments:-

1) Transco consider that the Top-Up Manager cannot delay booking of any Top-Up services if there is any possibility that the potential service will either not be available or be at a price that is likely to be more expensive than a service taken earlier. In fact the Code currently requires Transco to book its' Top-Up requirements by the 1st May. The primary interest of the Top-Up Manager is to secure the required service to ensure that security standards are met. The timing of the acquisition may result in higher or lower costs, but this is secondary to the need to acquire the service. With the advent of the Top-Up tender it is important that any delays do not create an incentive on tenderers to resort to ransom pricing.

2) Transco state that the Network Code requires the Top-Up Manager to be financially neutral with regard to Top-Up costs (and revenues). This fundamental principle requires the Top-Up Manager to recover all costs incurred and return all rebates received. Therefore there is no justification in rebating the full storage costs for services already received, but only give the rebate offered by the storage provider. It is assumed that no storage provider would offer a full rebate of costs if the service has been used. BG Storage have also charged for the services received in accordance with the Code.

3) Transco are clear that there is no justification for applying this proposal retrospectively as Transco have operated within the Network Code and have incurred eligible costs to ensure that Top-Up requirements are met. Furthermore to accept a retrospective modification in the Energy Balancing area could set a precedent for other retrospective modifications in Energy Balancing which Transco believe would not be in the general interests of shippers.

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

This modification goes against the relevant objective of providing incentives for gas suppliers to meet the domestic security standard by proposing that shippers do not pick up the full Top-Up costs that have been incurred.

4. **The implications for Transco of implementing the Modification Proposal, including:**
- a) **implications for the operation of the System and any BG Storage Facility:**
None
 - b) **development and capital cost and operating cost implications:**
This would increase Transco's operating 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:**
Transco believe it is appropriate for the Top-Up Manager to recover all the costs incurred in the Top-Up role.
 - d) **analysis of the consequences (if any) this proposal would have on price regulation:**
None
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:**
These unexpected costs would not be recoverable. This modification proposal erodes the principle of neutrality and may set a precedence for other retrospective energy balancing adjustments.
6. **The development implications and other implications for computer systems of Transco and related computer systems of Relevant Shippers:**
None identified
7. **The implications of implementing the Modification Proposal for Relevant Shippers:**
The modification would reduce the costs recovered through Balancing and Top-Up Neutrality. However a retrospective modification could result in a flurry of other retrospective Energy Balancing modifications which could result in substantial adjustments to Energy Balancing invoices.
8. **The implications of implementing the Modification Proposal for terminal operators, suppliers, producers and, any Non-Network Code Party:**
This does impact on gas suppliers - see below
9. **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:**
This modification brings into question Transco's Licence obligation to ensure that sufficient incentives are provided to gas suppliers if Transco are not allowed to recover legitimate costs incurred in the Top-Up role.

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

Advantages:- This modification results in lower Top-Up costs.

Disadvantages:- The level of incentive to gas suppliers to provide sufficient stored gas is reduced.

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

There were two responses received, both supporting the modification proposal.

BP Gas also stated that shippers fail to benefit from any recalculation of the Top-Up volumes, and the reduction in the Top-Up bookings. They also claim that the sole beneficiary of this is BGplc who are incentivised to overstate Top-Up requirements to benefit BG Storage.

AGAS claim that it was not reasonable and prudent of Transco to give misleading signals to the marketplace by levying the additional £11.7m. AGAS did however agree that both BG Storage and the Top-Up Manager acted according to the guidelines of the code. But the current mechanism of determining Top-Up is inappropriate.

AGAS suggest that the refund should come from BG Storage as they have exceeded their revenue cap by the same amount.

Transco Response:

In response to the specific points raised, Transco do not agree that shippers have not benefitted from reduced Top-Up bookings following the 1st October 1997 re-assessment. In fact shippers were given a rebate of £16m. Transco believe it is reasonable and prudent to implement the correct interpretation of the Network Code rules, which were applied to the letter. Unfortunately the size of the final rebate was found to be smaller than originally anticipated and shippers were advised of this as soon as Transco were aware of it.

Regarding the current Top-Up mechanism, see Transco's opinion in section 2 above.

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 comply with current safety or other legislation.

13. **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:**

None

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

None

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

Not applicable

16. **Recommendation concerning the implementation of the Modification Proposal:**

Transco recommend that this modification proposal is not 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 not to modify the Network Code and Transco now seeks direction agreement from the Director General in accordance with this report.

19. **Text provided pursuant to Rule 8.14:**

Not applicable

20. **Circumstances Relating to 8.5.6 Decision:**

In accordance with a previously agreed practice, an alternative modification proposal was not raised by Transco as it would have been exactly the same as that raised by BGT.

Signed for and on behalf of Transco

Signature:

John Lockett
Manager, Network Code

Date:

24. 6. 98

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 210, version 1.0 dated 19/06/98) be made as a modification to the Network Code.

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

Signature:

Kyran Hanks
Director of Transportation Regulation

Date:

The Network Code is hereby modified, with effect from _____, in accordance with the proposal as set out in this Modification Report, Version 01.0.

Signature:

Process Manager - Network Code
BG Transco

Date:

ANNEX

Restrictive Trade Practices Act - Suspense Clause

For the purposes of the Restrictive Trade Practices Act 1976, this document forms part of the Agreement relating to the Network Code which has been exempted from the Act pursuant to the provisions of the Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996. Additional information inserted into the document since the previous version constitutes a variation of the Agreement and as such, this document must contain the following suspense clause.

1. Suspense Clause:

1.1 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 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 paragraph 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996.

provided that if the Director does not so approve the Agreement then Clause 1.2 shall apply.

1.2 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 shall not come into effect until the day following the date on which particulars of this Agreement and of any such arrangement have been furnished to the Office of Fair Trading under Section 24 of the Act (or on such later date as may be provided for in relation to any such provision) and the parties hereto agree to furnish such particulars within three months of the date of this Agreement.