Modification Report
URGENT Modification Reference Number 265/265a

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, since the 11 June 1998 it has been necessary to take flexibility System Sells at St Fergus to resolve Transportation Constraints, the cost of which now exceeds £10 million. Urgent modification 265 was raised on 11 September and at an extraordinary meeting held on 17 September between shippers, Transco and Ofgas, it was agreed that Transco would raise an urgent modification proposal, Mod. 265a, based on the majority views of shippers present, to alleviate the cost of constraints at St Fergus.

2. Procedures Followed:

Transco agreed with Ofgas the following procedures for this Proposal;

a. An urgent modification would be raised on 17 September 1998 by Transco.

b. Close out for representations would be 17.00 on 18 September. The representations would consider both proposals, 265 and 265a.

c. The modification report would be sent to Ofgas on 21 September with the modification implemented shortly afterwards if appropriate.

3. The Modification Proposal:

Transco conducted a consultation on possible options to address the issues identified in Modification proposal 265. The results of this consultation were discussed at an open industry forum on 17 September where a number of options were discussed. Based on the majority view of shippers present at the meeting it was agreed that Transco would propose an alternative modification (Mod 265a) containing a package of measures consisting of the following short term changes. They are identified using the option names used in the consultations.

a. Delay Flexibility actions until physical flows indicate they are necessary (Option B)

Transco would make no constraint sells at D-1, but rely on managing pressures within day through constraint system sells as required. This would place more reliance on physical flows rather than nominations. Implementation of this proposal would require a modification to the Operational Guidelines.

b. Limit the price of bids that will be accepted to resolve constraints (Option C)

The price of constraint system sells would be collared at 0.00 p/kwh, in order to prevent negative priced bids being accepted to resolve a constraint. This would limit shipper neutrality exposure to excessive flexibility prices at constrained terminals.

c. Amend cashout price determination to remove asymmetry (Option D1 and D2)

As the cashout price is not affected by System Sells arising from transportation constraints, but any consequential System Buys are taken into account, the associated high volumes and high prices have a disproportionate effect on cashout, when constraint action is taken.

A means to correct this distortion is to exclude the flexibility bids taken to buy back gas following action to resolve a constraint from the cashout calculation and hence create a symmetry in terms of the flexibility actions.

The volume bought back (if any but only up to the quantity of that taken as a System Sell to resolve the constraint) within two hours following the flexibility action for constraint sell will be excluded from SAP. This was originally proposed in Modification 265 and is described as option D2 within proposal 265a.

In addition, Modification 265a includes an option, D1, to include System Sells in the calculation of System Average Prices which also has the effect of creating symmetry in the flexibility actions.

Shippers were asked to indicate their preference for either option D1 or D2 in their representations.

Given the desire for a temporary amendment it is proposed that once these changes are implemented they remain in place until 31 October 1998. This will give 5 weeks to assess their impact and determine any further appropriate action.

4. <u>Transco's opinion:</u>

Transco recognises that the costs associated with Transportation Constraints at St Fergus have given rise to £500,000 per day neutrality charges which are expected to continue at least in the short term. It is equally clear that the modification will not address the underlying causation of constraint costs, which will be tackled by the forthcoming NTS review. However, it should mitigate shippers exposure to excessive neutrality charges arising from flexibility actions associated with constraints.

Whilst shippers present on 17 September could not reach consensus on the most effective means to reduce constraint costs, there was agreement that something should be done to reduce the effects on the cashout regime. By a small majority shippers supported a recommendation that Transco progress the actions proposed in this modification.

Given uncertainty over the effects of the proposal, if implemented Transco will monitor closely the actions of Users and the financial impact of the modification to enable early action to be taken if necessary to rectify or ease any unforeseen adverse consequences.

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

Condition 7, relevant objective (a)

By reducing the incentive for shippers to deliver large quantities of gas at St Fergus, through amendments of the application of flexibility System Sells, the System will operate more efficiently.

This should lead to a reduction in the size and frequency of flexibility input sells and consequential buys and thereby limit the effect that these actions have on cashout prices.

Condition 7, relevant objective (b)

If as anticipated the costs of flexibility actions associated with constraints at St Fergus reduce, the financial impact on other shippers through neutrality will also diminish. This in turn will help maintain effective competition between shippers by reducing the burden on those who are bearing the costs of constraints.

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

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

Implementation of the modification should lead to reduced gas deliveries at St Fergus and a consequent reduction in the requirement for flexibility system sells at that terminal.

b) development and capital cost and operating cost implications:

Not applicable

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:**

Not applicable

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:

Not applicable

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

This modification will limit the price of bids that will be accepted at the constrained terminal to a minimum of zero. Shippers may need to consider the need to amend systems to prevent negative priced System Sell bids being posted for that terminal.

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

There should be a reduction in neutrality costs attributable to flexibility actions associated with constraints at St Fergus. This will be particularly beneficial for those shippers unable to participate in the current flexibility activity at that terminal.

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

In relation to part A of the proposal:
Any reduction in gas flows through St Fergus may impact on Producers costs. If System Sell actions are delayed until within the gas day then there may be some operational difficulties for terminal operators (DFOs). These could arise as the DFO will have nominations for gas flows to enter the terminal as a result of nominations on producers offshore and potentially a different instruction from Transco as a result of Transco issuing a Transportation Flow Advice notice, restricting the aggregate flowrate.

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:

It is anticipated that this will reduce the upward pressure on the forward price curve for gas sales.

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

Advantages -	Shippers could see reduced neutrality costs The risk of negative flex prices will be removed The size of flex actions may reduce Cashout prices should not be unduly influenced
Disadvantages -	May encourage shipper underdelivery Doesn't reflect market prices

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

The table included below summarises responses received. In most cases the respondents commented that a package of measures would be necessary to alleviate the issues. Additional comments were made as follows;

Option B: Delay Flexibility actions until physical flows indicate they are necessary.

There is widespread support for the proposal to delay taking flexibility action until within day (Option B) as this reduces or eliminates the potential for 'virtual' gas.

Enron comment that delaying flex action increases the likelihood that larger actions will be required to resolve the constraint. Agas raise the concern that the value of flexibility may be considered to increase during the day and this may encourage shippers to seek a higher premium for offering it. BGT are concerned that physical curtailment may lead to flow restrictions on contracts which cannot subsequently recover end-of-day quantities.

Total express great concern that the proposal could lead to safety problems of over-pressure within the sub-terminal as the physical flow cut-back will occur before the flexibility system sell. Total also refer to the issue of pricing of flexibility bids similar to Agas. Mobil fear that delaying action may lead to greater costs but on balance accept that it may also eliminate virtual gas. Yorkshire Energy support delaying action but comment that shippers may increase profiling.

Option C: Limit the price of bids that will be accepted to resolve constraints.

There is general support for the introduction of a zero floor price for acceptance of Flexibility Sell Bids to resolve constraints (Option C). Enron support a limit but suggest a floor price of -60 p/Therm. Agas state that negative prices may be a proper reflection of the supply and demand position in the mechanism and wish to resist introduction of pricing restrictions. Powergen also oppose the principle of an artificial limit on bid prices.

Total also oppose a floor price of zero, stating that this will reduce the number of posted bids. They state that associated gas producers will only find it economic to cut back flows with negative priced bids. BP also make this point. Yorkshire support a limit for sell prices but would prefer that it were linked to a market price differential. Many of those who support the proposal accept that a collar of zero is arbitrary and suggest that the limit should only be temporary.

Option D: Amend cashout price determination to remove asymmetry.

Option D1 Include all System Sell prices in the determination of cashout (Mod. 265a)

Option D2 Exclude System Buy prices from the determination of cashout where the buy actions are associated with a System Sell at a constrained terminal. (Mod. 265)

Regarding the treatment of flexibility bids taken to resolve constraints in the calculation of SAP and neutrality there is a split of opinion on whether Option D1 or D2 represents the best solution. There is a majority in support of some action to modify the treatment of SAP and restore 'symmetry in the costs associated with constraints' and Option D2 (to exclude related buy bids) is marginally preferred.

BGT do not support either proposal and are very concerned that the inclusion of System Sells into SAP (Option D1) will distort SAP downwards and encourage shippers to nominate 'short' and increase the System reliance on the Flexibility Mechanism to achieve overall balance. The additional volumes transacted through the Mechanism will increase neutrality costs. Of the two options they would prefer D2, to exclude the 'buy back' bids and thereby allow the flexibility mechanism and cashout prices to be more responsive to the NBP balancing requirement. This point is also made by MEB, Scottish Hydro and National Power. Total are concerned that the inclusion of Sell bids may depress the SAP below the Spot price.

Accord express concern that both options represent an abrupt and unforeseen amendment to the cash-out rules. Such a change has not been factored into shippers' ongoing gas trading strategies and a change without proper notice would be inappropriate.

Agas support the inclusion of constrained Sell bids in SAP as this is administratively simpler than Option D2 but would wish to exclude negative prices from the calculation. Dynegy support both proposals as they will mitigate upward price bias. On balance they prefer option D1 because it is simpler and the impact of including the sell prices in SAP may lead to a change in bidding behaviour. Yorkshire marginally favour D1 but do have concerns that if the buy side availability changed then this may result in an undesirable increase in neutrality costs. British Steel support D2 with the comment that "two wrongs don't make a right".

Table of representations on Modifications 265 and 265a

Respondent	Option B	Option C	Option D	Preference for D1/D2
Enron	Neutral	Y	N	-
Volunteer	Y	Y	Y	D1
Agas	N	N	Y	D1
Shell Gas Direct	Y	Y	Y	D2
British Fuels	Y	Y	Y	No clear preference
Southern Electric	Y	Y	Y	D1
Alliance	Y	Y	Y	D1
Regent	Y	Y	Y	No clear preference
Northern Electric	Y	-	-	-
Gas Light & Coke	Y	Y	Y	No clear preference
BGT	Y	Y	N	D2 preferred to D1
Scottish Power	Y	N	Y	D2
Powergen	Y	N	N	-
MEB	Y	Y	Y	D2
Vector	Y	Y	Y	D1
QGM	Y	Y	Y	D1
Marathon	Y	Y	Y	D1
QED	Y	Y	Y	D1
Louis Dreyfus	Y	Y	N	D2
Total	N	N	N	-
Accord	Y	N	N	D2
Reepham	Y	Y	Y	No clear preference
National Power	Y	Y	Y	D2
EIUG	Y	Y	Y	No clear preference
Conoco	Y	N	Y	D2
United	Y	Y	Y	D1
BP	Y	N	Y	D2
MGM	Y	-	Y	D2
Dynegy	N	N	Y	D1
YE	Y	Y	Y	D1
British Steel	Y	Y	Y	D2
Scottish Hydro	Y	Y	N	-
Eastern	Y	N	Y	D2

<u>Transco Response:</u>

Transco do not support the implementation of Modification 265 as this does not provide sufficient measures to resolve the current issues.

Transco support the implementation of Modification 265a, adapted to include options B, C and D2 described above but believe that option B should be delayed until the Health and Safety issues raised by Total have been addressed to the satisfaction of both Ofgas and the HSE. Transco believe that this modification presents an interim solution to contain costs of constraints at St. Fergus. Although the implementation of Option D2 is more complex it does address the concern that the costs of constraints may be distorting the prices in the cashout regime.

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

Transco believe that this proposal does not present a Safety Case issue for Transco but believe there is a potential for over pressure conditions to be generated within the affected sub-terminals.

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:

Not applicable

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

The implementation of this modification will require additional manual processes within Commercial Operations. A programme of works will not be required.

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

Immediate implementation following Ofgas approval.

18. Recommendation concerning implementation of the Modification Proposal:

Transco recommends that options C and D2 described in modification proposal 265a should be implemented. Transco also recommend that a decision on the appropriateness of option B should not be taken until the issues raised by the HSE in a letter to Ofgas on 18/9/98 have been addressed.

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.

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20. **Transco's Proposal:**

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

21. **Text provided pursuant to Rule 9:**

Text attached

Signed for and on behalf of Transco.

Signature: John Lockett

John Lockett
Manager, Network Code

Date: 29.9.98

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 265/265a, version 1.1 dated 22/09/1998) be made as a modification to the Network Code.

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

Signature: Rebecca Purves REBECCA PURVES HEAD OF GAS BALANCING

Date: 29 September 1998

The Network Code is hereby modified, with effect from 30/9/98, in accordance with the proposal as set out in this Modification Report, version 1.1.

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.