

URGENT Modification Report
Revised Energy Balancing Incentive Arrangements post April 2002
Modification Reference Number 0542
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.

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 that revised System Operator Incentives will be implemented with effect from 1st April 2002. However, the Gas Transporter (GT) Licence conditions will not be in place to deliver this before 1st April 2002. Transco therefore sought urgent status for this Network Code Modification Proposal to ensure that these revised arrangements can be put into affect on a transitional basis by the due date.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal: The timetable for the Modification Proposal to follow urgent status is set out below.

<i>Issued to Ofgem for decision on urgency</i>	<i>13 March 2002</i>
<i>Proposal agreed as urgent</i>	<i>13 March 2002</i>
<i>Proposal issued for consultation</i>	<i>14 March 2002</i>
<i>Close out for representations</i>	<i>20 March 2002</i>
<i>Final report to Ofgem</i>	<i>22 March 2002</i>
<i>Ofgem decision expected</i>	<i>27 March 2002</i>

1. The Modification Proposal

Transco proposes to introduce the following changes to the current Price and Linepack Incentive Arrangements detailed in Section D of the Network Code. These amendments would be effective from 1st April 2002.

The proposal is to:

- Increase the Maximum Incentive Amount for superior performance for each of the above incentives to £5000.
- Increase the Annual Maximum Incentive Amount in respective of both Incentive Arrangements to £3.5 million for both superior and inferior performance.

In addition it is proposed to amend the Network Code such that payments/rewards associated with this incentive will no longer be invoiced via the schedule ADF invoice as is currently the case.

2. Transco's Opinion

Transco considers that this Proposal will provide clarity as to the Residual Balancing Incentive that will apply from 1st April 2002. Transco anticipates that implementation of this Modification Proposal will help to reduce the reconciliation amount subject to the reconciliation process that may otherwise be necessary if the current regime were allowed to continue but was then superseded by amendments introduced retrospectively following revisions to its GT licence. Transco does however recognise that any variance between the SO incentive arrangements described in this Proposal and those set out in the final GT Licence conditions means a reconciliation process may be necessary.

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

Implementation of this Modification Proposal would facilitate compliance with the relevant objectives 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:

Transco does not anticipate any significant implications.

b) development and capital cost and operating cost implications:

Transco does not anticipate any such implications.

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:

Transco does not anticipate any such consequence.

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 anticipate any such consequences.

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

This Modification proposes the removal of a scheduled ADF invoice for charges/credits arising from the Linepack and Price incentive arrangements. Appropriate notification of the removal of the production of this invoice will be required. This may impact related computer systems of Users.

7. The implications of implementing the Modification Proposal for Users

Due to changes in the Linepack and Price Incentives cap and collar, Users, exposure to these incentives may increase. However increasing Transco incentive by these amounts may also lead to greater residual balancing efficiency, which will benefit all participants.

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

No such implications are anticipated.

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, under its GT Licence amendments. The proposed licence amendments are to be the subject of a consultation under section 23 of the Gas Act 1986 and no assumption can be made regarding the outcome of that process.

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

Advantages:

- the Proposal better reflects Transco's understanding of the proposed GT licence conditions.
- a reconciliation process, to adjust incentive revenues post 1st April 2002, may not be required.
- the Proposal provides clarity as to the Linepack and Price incentives that will apply post 1st April 2002.
- will ensure the incentive is active from 1st April 2002.

Disadvantages:

- Users may have to revise their invoicing processes in respect of the removal of the scheduled ADF invoice for credits/charges associated with Linpack and Price incentives.

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

Representation have been received from eight respondents.

Powergen UK Plc	Powergen
Norsk Hydro (UK) Ltd	Norsk Hydro
Agip (UK) Ltd	Agip
Scottish and Southern Energy Plc	SSE
Innogy Plc	Innogy
British Gas Trading Ltd	BGT
Shell Gas Direct Ltd	SGD
TotalFinaElf	TFE
LE Group	LE

Four respondents express support for this Modification Proposal (Innogy, Norsk Hydro, BGT and Powergen).

Three respondents (SGD, TFE and LE) are not in support of this Proposal.

Two respondents (SSE and Agip) do not offer a definitive position.

Incentive Revenue Flows

Five respondents (BGT, Innogy, Norsk Hydro, SSE SGD and LE) observe that it remains unclear how this Proposal fits with other Proposals or how revenues will be collected and redistributed. Innogy observes that within the industry there is still insufficient understanding of revenue flows, interactions with other SO incentive components and relationship between Transco's SO and TO roles. Innogy questions what, *"The precise definition and range of Transco's trading role under the new incentive arrangements is..."*. BGT observes that *"To date no further information has been available on the proposed amendments to the licence in order to gain an appreciation of the method by which these incentives arrangements will apply"*.

Norsk Hydro and SSE request greater clarity about the way in which the performance payments arising from the incentive will be channelled through the SO commodity charge. SSE notes that charges have been set on the basis that Transco is neutral and questions how the charges would be adjusted to reflect superior/inferior performance. Norsk Hydro states that, *".. an assumed incentive position for Transco would be agreed and that this would be funded through the SO Commodity charge but the forecast sum for 2002/3 is not stated"*, Norsk Hydro requests that Transco provide details on the mechanism that will apply post April 2002.

SSE observe that there may be a mismatch between the year that the incentive is

operational and the recovery of any reward/penalty via the SO commodity charge and suggests that there may be a mis-allocation of costs across Users throughout for a different period, because of a changing portfolio position.

Transco's Response

Transco advises that the revenue flows resultant from the Linepack and Price incentives will be consistent with the approach set out in Pricing Consultation paper PC70.

Transco confirms that in accordance with PC70 no specific mechanism for payment/reward for performance under the incentive schemes is proposed. Any adjustment to revenue which Transco seeks to collect will be duly notified via adjustments to the SO commodity charge. The proposed process will compare the net reward or payment from both incentives on all days whether performance was inferior or superior against either a cap or collar depending on the value calculated. The amount beyond the cap or collar will be the adjustment value taken into account when setting the SO commodity charge.

This Modification Proposal does not propose any changes to the current range or definition of Transco's trading role. The definitions of Transco Marginal Prices, System Marginal Prices and the interaction of Energy Balancing with Capacity will remain unchanged under this Modification Proposal.

In response to SSE concerns relating to the mismatch between the operational and recovery year, Transco advises that the mechanism by which the charges from the Linepack and Price incentives are levied were consulted on as part of the pricing consultation paper PC70 and, therefore, will be effective from 1st April 2002.

Modification Proposal 0519 - Removal of Balancing Incentives from Code.

Innogy notes that it is unclear whether it will be necessary for additional proposals to remove the proposed changes to the Network Code once Transco's GT Licence is in place and how this Proposal fits with Modification Proposal 0519. It requests some clarification on this issue.

SSE suggests that if this Proposal is implemented there needs to be a mechanism to remove it and suggests that this could be achieved by initiating further consultation on Modification Proposal 0519.

SGD states that, *"In the absence of a decision from Ofgem, we can only assume that Transco has made this Proposal in anticipation of acceptance by Ofgem of Modification 0519"*.

Transco's Response

Transco advises that the legal text for this Modification Proposal has been drafted with the intention that Modification Proposal 0519 may be implemented to remove such transitional energy balancing incentive provisions upon implementation of Transco's GT Licence conditions. If this proves not to be the case then a further Modification Proposal may be required.

Inferior Performance

SSE requests confirmation that both the Linepack and the Price incentive will retain Transco's daily exposure of £30K.

Transco's Response

Transco confirms that this assumption is correct.

SO Incentive Alignment with GT Licence Amendments

BGT accepts that, *"... it would not be appropriate to continue with the regime as currently drafted in the Network Code, as this would not have been representative of the more commercial incentives which Transco will be subject to"*. Two respondents (SSE and Innogy) express the view that they are sympathetic to Transco's pragmatic approach in raising this transitional Modification Proposal so that incentive arrangements may be more closely aligned to those included in the New GT Licence conditions. Innogy suggests that it may offer shippers more certainty about the regime from April 2002 but observes that, *"...there is still the risk of reconciliation depending upon the exact form of the licence amendments finally implemented"*. This is a view that is shared by SSE which observes that, *"...there is no guarantee that the SO incentive would be introduced as currently envisaged"*. Innogy advises that it is assumed that this Proposal's consistency with the licence proposals will lead to a smooth transition to the enduring arrangements.

Transco's Response

Transco welcomes the view expressed by the respondents and advises that although every effort has been made to ensure consistency between this Proposal and the SO Incentive final proposals, anticipating that this will reduce the need reconciliation processes, Transco recognises that any such reconciliation process is dependent on the exact form of Licence amendments.

GT Licence Proposals

Innogy suggests that, *"...this Modification Proposal appears consistent with the high-level principles set out in the final SO proposals..."*, however it adds that it is difficult to comment on this Proposal meaningfully without having seen the detailed licence proposals. This is a view shared by a number of respondents (Innogy, SGD, Norsk Hydro). Four respondents (BGT, SSE, SGD, TFE and LE) express concern that Users are being asked to comment on a Network Code Modification Proposal that is required to facilitate implementation of Licence conditions which they have not yet seen drafting of, nor provided comments on. Norsk Hydro states that, *"... it considers it unacceptable to be presented with partial information and an incomplete process"*. TFE believes that, *"...due process dictates that until the proceeding matters of licence changes and SO incentives are finalised and accepted, the arrangements set out in this Proposal cannot and therefore should not be implemented"*.

LE believes that, *"...the need for this Modification has arisen because of Ofgem's inability to complete the final changes to the GT licence which Transco agreed 'in principle' at the end of January 2002"*.

SSE expresses, *"...grave concerns that as yet Transco's licence conditions have not been finalised and agreed before the start of the price control period"*.

Innogy and BGT express disappointment with the delay to the publication of the GT Licence amendments and observe that the delay has required an Urgent Modification Proposal to the Network Code rather than a considered amendment to Transco's GT Licence.

SGD notes that the inability of Users to propose modifications to the GT Licence which impact the market, *"...must have a detrimental effect on the efficient operation of the pipeline system and may undermine effective competition between Shippers"*.

TFE believes that, *"...there should be no changes to the Network Code that are associated with 'anticipated' implementation of SO incentive proposals via 'anticipated' acceptance of revised licence changes until Transco is able to make an unequivocal binding commitment to these fundamental contractual issues"*.

Transco's Response

Transco understands the concerns expressed in terms of the difficulties faced in responding meaningfully to this Proposal in the absence of the GT Licence drafting. However, in putting forward this Proposal Transco is seeking to put in place a pragmatic response to this situation. The implementation of this Proposal will ensure that transitional provisions are in place, from 1st April 2002, that reflect Transco's understanding of Ofgem's final proposals for SO Incentives and, as such, provides the industry with clarity as to the structure of incentives post this date.

Appropriate Governance of the SO Incentive Arrangements.

Both Powergen and Agip express support for this Modification Proposal. However they consider that in the longer term the SO incentive arrangements should remain in the Network Code rather than being included within Transco's GT licence. Powergen expresses the view that although it is in support of this Modification Proposal it considers that it is more appropriate that these incentives are located in the Network Code and argues for, *"... incentive parameters to be in the Code so that Market Participants have the opportunity to amend the parameters in response to changing market conditions,.."*. Agip adds that inclusion of these arrangements in the Network Code means that not just Ofgem and Transco can propose amendment to the incentives. Powergen concludes that it is inappropriate and inflexible to include trading arrangements in Transco's Licence conditions and believes that this will become more apparent when the industry wishes to change the SO incentive parameters in the light of operational experience.

SGD recalls that in its response to Modification Proposal 0519 it outlined concerns that moving SO incentives arrangements to Transco's licence increases the role of the Regulator at the expense of shippers which it believes to be, *"...against Ofgem's stated objectives of reducing the burden of regulation"*.

Transco's Response

Although Transco notes the views expressed, it has accepted Ofgem's proposal that new SO incentive arrangements should be effective from 1 April 2002. Transco believes that any concerns over the governance of the SO incentives should be expressed within the consultation process regarding GT Licence amendments

Timescale of Implementation

SSE raises concerns over the timeliness of Ofgem's granting urgent status and that, according to the timetable, the decision for this and other related Modification Proposals is unlikely to be made before 28 March. Three respondents (SSE, Innogy and BGT) suggest that this leaves little time for the Users to modify their processes to take account of these potential changes. BGT suggests that, *"The short timescales will inevitably result in the need for manual processes to manage routine operations"*. Innogy suggests that the Urgent status, requiring implementation of changes by April 2002, indicates an increased level of risk that insufficient consideration is given to this Proposal.

Transco's Response

Transco sympathises with the concerns expressed by SSE and BGT. Having subsequently consulted with Ofgem on this matter, Transco advises that Ofgem will endeavour to make a decision in respect of this Modification Proposal as soon as possible.

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

Transco does not anticipate any such requirement.

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

Transco does not anticipate any such requirements.

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

System and operational changes are currently believed to be minor, and therefore only a minor programme of works is required.

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

If Ofgem direct implementation, Transco recommends that this should take effect from 1 April 2002.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation of this Modification Proposal.

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

Delete paragraph 8.2.1

Add new paragraph 8.2.1. to read as follows:

- 8.2.1. D.3. With effect from 1 April 2002 the Energy Balancing Incentive Arrangements shall continue to apply as amended by paragraphs 1 to 14 below:
- (1) The Maximum Incentive Amount Limits set out in paragraphs 3.1.5.b.(i) and (ii) shall be increased to £5000;
 - (2) Paragraph 3.1.5. (c) shall not apply and the Annual Maximum Incentive Amount shall be the upper limit of the Net Aggregate Annual Amount (described in paragraph 10 below) and shall be set at £3,500,000, whereas the lower limit of the Net Aggregate Annual Amount, the “Annual Minimum Incentive Amount” (which number shall be negative) shall be set at £3,500,00;
 - (3) Paragraphs 3.1.1 and 3.1.5.d. shall not apply.
 - (4) Amend paragraph 3.1.3.(a) to read “ the “Incentive Performance Measure” is....”
 - (5) References within paragraph D.3. to a Gas Year shall be deemed to be a reference to a Formula year;
 - (6) a “Formula Year” means the period from 1 April in any year to 31 March in the following year;
 - (7) In respect of both the Price Incentive Arrangement and the Linepack Incentive Arrangement and within a Formula Year Transco shall calculate the Daily Incentive Amounts for both superior and inferior performance;
 - (8) Delete paragraph 3.2.4;
 - (9) In respect of both the Price Incentive Arrangement and the Linepack Incentive Arrangement and in respect of a Formula Year Transco shall then calculate the Aggregate Annual Amount in respect of that Formula Year;
 - (10) Having calculated such Aggregate Annual Amount in relation to both superior and inferior performance in accordance with paragraph 3.3., Transco shall then calculate the net difference of such sums, the “Net Aggregate Annual Amount”;

- (11) The Net Aggregate Annual Amount shall then be comprised and form part of the NTS Commodity Charge in accordance with the Transportation Statement and shall be invoiced in accordance with the manner for such charge set out within Network Code;
- (12) To the extent that the Net Aggregate Annual Amount is greater than the Annual Maximum Incentive Amount then only that maximum amount shall be comprised and form part of the NTS Commodity Charge as described in 11 above;
- (13) To the extent that the Net Aggregate Amount is less than the Annual Minimum Incentive Amount then only that minimum amount shall be comprised within and form part of the NTS Commodity Charge as described in 11 above.
- (14) Paragraphs 3.4 to 3.7 (inclusive) shall not apply.

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 **0542**, version **2.0** 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 **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 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.