

Modification Report
Change to the cash-out arrangements where Transco defines Operating Margins (OM)
gas usage for end of day balancing purposes
Modification Reference Number 0607
Version 1.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

Transco would calculate an OM unit cost (in p/kWh) and publish these costs in accordance with rules set out in the Network Code. When OM gas was used, Transco would determine at the time whether the OM gas was used for system balancing (i.e. within day balancing and/or NTS constraints/compressor failure) or end of day balancing purposes. Where Transco determined that OM gas was used for end of day balancing purposes, the OM unit cost would be included in the calculation of SMP cash out prices as if it had been an action taken on the OCM. If the OM unit cost was above the highest priced balancing action taken by Transco for that day, the OM unit rate would be used in the determination of the System Marginal Buy Price (via revision of F 1.2.1 (i) (b)). Similarly if the OM unit cost was the lowest priced balancing action taken by Transco for that day then it would be used in the determination of the System Marginal Sell Price (via revision to F 1.2.1 (ii) (b)) This Proposal does not advocate amending the basis for the calculation for the System Average Price. If the OM unit cost was below the highest prices balancing action taken by Transco for that Day, the System Marginal Buy Price would be the highest priced action on the OCM.

2. Transco's Opinion

Transco notes that the intention of the Modification Proposal is to increase the incentive on Users to balance. The Proposal advocates that this would be achieved by defining a mechanism whereby a cost and value related unit price for potential OM utilisation is derived and this price would contribute to the determination of the daily SMP Buy price when OM is used for end of day balancing. Transco would determine, at the time of usage, if OM was being used for end-of-day balancing purposes.

The Proposal defines a methodology for determining a unit cost associated with OM gas utilisation. This unit cost would be SAP plus an increment, the increment reflecting an average cost of the non-gas elements of OM (based on an assumption that the OM gas requirement will be used). The Proposal defines that the treatment of the price associated with OM utilisation for end-of-day balancing purposes would be analogous to that associated with the price of any other Market Balancing Action used for the purposes of determining the SMP Buy price. The Proposal could lead to stronger incentives to balance on days of OM usage but these events are very rare.

There have been no incidents of OM usage over the last three winter periods that have been categorised as being for end-of-day balancing purposes. Transco notes that the NT&T Workstream accepted the principle that the existing control room processes would be used to define whether any OM usage is taken for end-of-day balancing purposes.

Transco considers that implementation of this Proposal might strengthen Users' incentives to balance. However, there is a risk that, on a particularly 'short' day, OM used for end-of-day usage, due to demand change or supply loss, might generate an SMP buy price of SAP plus the increment reflecting the average non-gas cost OM element. This increment, which might represent approximately 40 p/Therm might further inflate the SMP buy price when it might already have reflected a fair market value taking account of the shortage of gas.

There is a risk that Transco could define OM usage as for end-of-day balancing purposes when later events suggest that this may not have been the appropriate decision. It should be noted that the circumstances that are most likely to result in Transco declaring that OM utilisation is for end-of-day balancing purposes are when actions need to be taken very late in the day. When such actions are taken, Users might not have time to respond to the increased cash-out prices. The OM service offers a form of insurance against such events, which Users effectively pay for, at least in part, via the SO Commodity charge.

Transco feel that the benefit of any potential improved cost reflectivity arising from implementation of the Proposal, given the very rare expectation that OM utilisation will influence the SMP buy price, would be outweighed by the combination of implementation costs of an automated I.T. system for feeding OM costs into cash-out the price determination process and the higher levels of risk imposed on Users that might not be warranted. The high implementation costs could be mitigated by the use of a manual process but this would introduce additional risks arising from the complexity of the processes of determining cash-out prices and checking invoices.

On balance, and taking into account the views of Users, Transco concludes that the benefits of the Proposal do not outweigh the expected costs and increased levels of unwarranted User risk and hence Transco does not support the implementation of the Proposal.

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

The Proposer states that this Proposal would better facilitate the relevant objectives of the efficient discharge by Transco of its obligations under its Licence in respect of the economic and efficient operation of the pipeline system. The Proposer also indicates that it is envisaged that it would facilitate competition between Shippers and Suppliers by reducing the potential for cross subsidies. By improving cost reflectivity, particularly on peak days, the Proposal would better facilitate the objective of providing reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards (within the meaning of paragraph 4 of Standard Condition 32A (Security of Supply " Domestic Customers) of the standard conditions of Gas Suppliers" licences) are satisfied as respects the availability of gas to their domestic customers.

4. The implications for Transco of implementing the Modification Proposal , including
a) implications for the operation of the System:

Increasing the incentive on Users to attain an end-of-day balance might lead to reduced within-day mismatches between NTS input and offtake flow rates, which in turn might lead to reduced flow and linepack variation. Should this occur it would benefit the economic and efficient operation of the System.

b) development and capital cost and operating cost implications:

Changes to Transco's existing systems would be required to automate the revised cash-out price derivation process. Transco's provisional estimates suggest that development and implementation costs would be in the order of £100k. Additionally, modest operating costs might result from the requirement to derive and publish the assessment of the non-gas cost contribution to the OM 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:

Any additional System Operator costs would be shared with Users as defined within the internal cost incentive scheme defined in the GT licence.

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

The proposal is not considered to have any consequences in respect of price regulation.

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

No such consequences are anticipated.

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

Transco has estimated that automation of the processes associated with implementation of the Proposal would lead to system development and implementation costs in the order of £100k.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Proposal might result in a changed level of risk to Users due to the potential increased exposure to cash-out prices at peak demand levels.

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

Transco does not believe that there would be a direct effect on the above parties.

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

No changes to contractual relationships are anticipated.

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

Advantages

- The price of OM gas might influence cash-out price determination.
- Users' incentive to balance might be increased.

Disadvantages

- Increased uncertainty regarding cash-out prices (no longer solely based on transactions taking place on the EnMO provided Trading System.)
- Additional costs and risks associated with managing a manual cash-out price determination process.

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

Parties responding:

Entergy-Koch Trading Limited (EKT)	Against
TXU	Against
Innogy	Qualified Support
ConocoPhillips (U.K.) Ltd (CP)	Against
Powergen plc. (PG)	Against
LE Group (LEG)	Qualified Support
EnMo Ltd	For
British Gas Trading (BGT)	Against
TotalFinaElf Gas and Power Ltd (TFE)	Against
Scottish Power (SP)	For
Shell Gas Direct (SGD)	Against

General

Seven parties were against the proposal; two parties were in favour of the proposal and two parties offered qualified support.

Appropriateness of the mechanism

Five respondents (Innogy, PG, LEG, EnMo, SP) agreed that including OM gas that is used for end-of-day balancing purposes would produce more cost reflective cash-out prices. Two respondents (TXU, CP) felt that it would be an unnecessary cost reflectivity. Two respondents (CP, TFE) commented that on days when OM gas is used for end-of-day energy balancing, market prices would be reflecting the shortage of gas and the addition of an OM gas unit price would only serve to exacerbate the situation.

Transco's Response

Transco believe that the proposal might strengthen Users incentives to balance and furthermore, it is on days of extreme demand when market prices are high that an appropriately large differential between SAP and SMP buy might be required to incentivise gas delivery in line with User nominations. Transco recognise, however, that the application of the average cost of the non-gas cost elements of the OM costs may artificially inflate the SMP buy price. Transco consider that it is likely that the SAP and SMP prices might, without the application of this increment to the SAP for SMP buy price determination process, already provide an appropriate price signal.

System v Energy Balancing Actions

SP have concerns over the methodology that could be applied by Transco in making a determination as to whether OM gas is used for end of day energy balancing purposes or system purposes. TFE are not convinced that it is possible to neatly attribute OM usage to either a "system" or "energy" balancing action. EnMo believe that Transco are in the best position to judge whether actions taken on its system are for system or end of day balancing and would be ideally placed to derive the cost and value related to the OM utilisation.

Transco's Response

If the proposal were to be implemented, Transco would define whether an OM action was for within-day or end-of-day purposes at the time of OM utilisation. This decision would be based on the length of OM usage and the time-frame of the incident. The main criteria that Transco would use would be if information available at the time indicated that the impact of the incident, given available gas supplies, was likely to result in an unacceptable end-of-day imbalance unless OM gas was utilised.

Other Relevant Costs

EKT consider that it is valuable to include all of the relevant costs in the calculation of cash-out, however there are some larger policy issues yet to emerge and there may be a need to consider the inclusion of other costs beyond operating margins gas.

Transco's Response

Transco are unaware of any other relevant costs that could be considered for inclusion in a revised cash-out mechanism.

Cost Targeting & Incentives to Balance

A number of respondents commented on the appropriateness of the modification in regard to cost targeting.

Transco's analysis showed that no operating margins gas was used for end of day gas balancing purposes over the last three winters. 3 respondents (EKT, TXU, CP) commented that this indicated that costs are already being well targeted. SGD do not agree that there are, or likely to be, "significant cross-subsidies". It is unlikely that this leads to cross-subsidies of such significance that changing the regime to ensure targeting would be efficient for the industry. SGD consider that OM use by Transco is key to the safety of the system and it is reasonable to have this cost as an insurance cost.

Two respondents (SGD, LEG) commented that it is not necessarily the case that all shippers that are short when there is a beach failure will have a relationship with the terminal where the failure occurred. The proposal would create the risk of high costs to shippers who are short on any day, making it more likely that shippers will try to be wrong to avoid this risk. This will not improve balancing but distort it.

Transco's Response

Transco agree that the proposal will not necessarily better target costs directly. The prevailing OM cost recovery mechanisms will remain in place but the neutrality mechanisms will redistribute costs. Cash-out price determination has never been intended to precisely target costs but rather to provide appropriate incentives on Users to balance whilst at the same time being, as far as is practical, cost reflective. Transco believes that on the very rare occasions when OM gas is used for end-of-day balancing that implementation of this proposal would be likely to increase incentives to balance.

Transparency & Usage

One respondent (Innogy) commented that the process that Transco intends to use for distinguishing between system and end-of-day balancing OM gas usage needs to be transparent and well defined. Two respondents (Innogy, CP) would appreciate clarification as to how any bundled storage costs will be derived and would prefer that the OM unit gas cost was known ex ante, such that shippers can make an informed decision about mitigating their potential imbalance exposure.

Two respondents (CP, PG) were concerned with the reliance on Transco to tag their usage of OM gas as within day or end of day requirements. The example was given where an earlier system failure requiring OM gas, may continue and create an end of day energy balancing situation, for which the cash-out price would reflect the cost and shippers become exposed to the OM unit cost price.

Transco's Response

If the proposal were to be implemented, Transco would define the incremental OM price at the beginning of the gas year. This price would be added to SAP to generate an action trade price in the event of OM being used for end of day balancing purposes.

OCM

EnMO state that they " understand the crucial role that real time cash-out price determination plays within its business model and confirm that should Modification 607 be implemented, then EnMO would proceed with systems development to meet this requirement with the costs of developing the change not feeding through to its clients. (Overall costs to introduce this change to EnMO's systems and the OCM (On-the-day Commodity Market) would be in the region of £25,000).

Finally in supporting Modification 607, we do so on the strict understanding that Transco would inform EnMO within a timely manner and certainly within the same balancing period of OM usage for end of day balancing, such that quick and accurate changes may be made to the SMP displayed prices. EnMO would welcome working alongside Transco to develop operating procedures whereby this may be achieved."

Transco Response

In the event that the proposal were implemented, Transco would also welcome working alongside EnMo to develop operating procedures such that the use of OM for end-of-day purposes could be reflected in the SMP buy price in a timely fashion.

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

Transco does not believe that implementation of this Modification Proposal would affect compliance with 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 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Not applicable

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

Considering the high costs of fully automated IT solutions Transco would envisage that, should the proposal be implemented, a series of primarily manual off-line processes would be introduced to calculate and publish the OM incremental price.

Additionally, the programme of works would also include;

- Implementation of internal procedures to ensure OM usage for end of day balancing feeds cash-out determination process.
- Set up communication methods to ensure that the community are aware of OM usage for end of day balancing purposes in a timely manner.

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

Transco would envisage that, should the proposal be implemented, processes would be introduced to calculate and publish the OM incremental price for September 2003 and each September thereafter.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of the 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 not to modify the Network Code in respect either the original or alternative Modification Proposals and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

Signed for and on behalf of Transco.

Signature:

Nigel Sisman
Development Manager - Gas Balancing
NT & T

Date: