Modification Report
Recompense in the Event of Late Completion of Works for New System Entry Points
Modification Reference Number 0680

Version 1.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

It is proposed that for each gas day for which gas can not be accepted for delivery prior to first gas flow in accordance with previously allocated System Entry Capacity due to non-completion by Transco of the connection between a new Aggregate System Entry Point and the gas transmission system, relevant Users would not be invoiced for its allocated System Entry Capacity at the Aggregate System Entry Point. This does not include circumstances where third party works (excluding Transco sub-contractors) are not complete that are required to allow gas to be accepted for delivery, regardless of whether Transco works are complete.

2. Transco's Opinion

Transco recognises that in the event that it is late in completing a connection that it has undertaken to build between a new Aggregate System Entry Point and its existing gas Transmission System, it has no obligation, under Network Code, to accept gas for delivery by the Users holding capacity at that Aggregate System Entry Point. There is thus no mechanism under such circumstances to provide recompense for a User's inability to flow gas against its capacity holding.

Transco considers that under such circumstances relevant Users should be alleviated of their obligation to pay for their capacity holdings. It is proposed that this is achieved by not invoicing relevant Users for their capacity payment for each gas day for which the required Transco works (to provide capacity) are not complete beyond the agreed delivery date. However, the provision would not apply in the event that an inability to deliver gas is caused by delays in non-Transco works.

Transco recognises that this approach would differ from present arrangements for existing System Entry points for which it is obliged to manage capacity through the buy-back mechanism. It is considered that this arrangement is inappropriate for new Aggregate System Entry Points as Transco would have to buy-back all the sold capacity regardless of actual intended flow rates and hence would be a distressed buyer, potentially exposed to the maximum buy-back prices permitted in the RGTA capacity system.

Transco considers that this Proposal would increase its incentives, in circumstances where it was obligated to provide entry capacity by an agreed date as it would otherwise suffer the loss of revenue under the Entry Capacity Investment Incentive for each gas day for which works (to enable Transco to accept gas properly tendered for delivery) which are late.

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

Implementation of the Proposal would provide an additional incentive for Transco to complete works associated with new Aggregate System Entry Points in a timescale that is consistent with the commitments given when System Entry Capacity is released. Incentives to facilitate the timely connection of new Aggregate System Entry Points would further the economic and efficient operation of the transportation system.

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

a) implications for the operation of the System:

Transco has not identified any implications for operation of the System.

b) development and capital cost and operating cost implications:

Transco has not identified any additional capital cost or operating cost implications. The facility to not invoice relevant Users for its capacity holdings for certain gas days is already part of the Project Gemini functional specification.

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 is not proposing to recover any development or capital costs arising from implementation of this Proposal.

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

Transco believes that, in instances of late provision of new entry capacity at a new ASEP, revenues allowed under the Entry Capacity Investment Incentive may need to be modified to disallow previous forecast revenues.

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

Implementation of this Proposal would increase the level of contractual risk to Transco as failure to complete the works by the agreed date would result in loss of revenue under the Entry Capacity Investment Incentive.

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

Transco considers that Transco computer systems would be in a position to provide the required functionality for implementation of this Proposal without major development and is unaware of any development implications for Users' computer systems.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Proposal would ensure that in the event of late commissioning of a new Aggregate System Entry Point, Users would not face the associated Entry Capacity charges until Transco's connections works (to enable it to accept gas properly tendered for delivery) are complete unless the upstream third party works have not been completed to allow the physical flow of gas.

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

Users might wish to reflect any recompense received from Transco in any relevant arrangements they might have with upstream 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

Transco has not identified any such consequences.

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

Advantage:

- Transco believes that the assurance of recompense, for non-availability of entry capacity at new Aggregate System Entry Points, due to non-completion of Transco works (to enable it accept gas properly tendered for delivery), equal to the amount placed on the entry capacity via the auction process would encourage Users to participate in such auctions.
- Transco also believes that implementation of the Proposal provides an incentive for Transco to ensure timely completion of its connection works.

Disadvantage:

- The level of contractual risk on Transco would increase, although Transco believes that the change is proportionate to the potential rewards available to Transco for timely connection of a new Aggregate System Entry Point.

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

Eight representations were received to the Proposal:

Respondent	Response
Statoil (UK) Limited (Stat)	Qualified Support
British Gas (BGT)	Qualified Support
Shell Gas Direct Limited (SGD)	Qualified Support
Exxon Mobil Gas Marketing (EXX)	Qualified Support
PowerGen UK plc (PG)	Qualified Support
Scottish Power (SP)	Not in support

SSE Energy Supply Ltd (SSE)	Qualified Support
Edf Energy plc (Edf)	Support

Edf noted that it would "provide Transco with the incentive to ensure timely connection of its connection works and could encourage Users to participate in such auctions". SSE believed that "it would provide some incentive for Transco to avoid or minimise delay", whilst Stat noted that "it would provide some mitigation of costs". SGD considered that the Proposal "furthers the Relevant Objectives of the Network Code" and "will provide better incentives on Transco to complete connection of new entry points".

The following issues were raised:

11.1 Amount of Recompense

Although the Proposal was supported by the majority of respondents, there was a general view that the proposed amount of recompense would not necessarily cover the costs incurred by Users.

Stat did not consider that "the absence of a capacity charge would truly reflect the cost of late delivery of investment" and SSE expressed concern that "the level of compensation may not be sufficient to cover commercial or consequential loss suffered". SGD "do not consider recompense offered by this proposal to be sufficient".

BGT argued that "compensation should be related to the differential cost of delivery of the equivalent amount of gas at an alternative entry point." This point was shared by EXX, who suggested that Users may have to make "alternative market arrangements". EXX further claimed that the Proposal is "an insufficient scheme to give confidence to Users that works for new System Entry Points will be completed on time. As such there is a risk of delays to GB receiving new gas supplies". Stat also pointed out that "Failure to connect these [entry terminal] facilities to the NTS in a timely fashion can have significant consequences" and "could represent a major risk to new investment as well as network security."

Two respondents considered the value of the capacity bought. PG suggested that the value "does not equate to the value of that capacity when it is not available." SP claimed that a "straight "refund" is not appropriate" and did not believe that the value at the point of purchase will reflect its value in future years.

Transco Response.

The main objective of the Proposal is to introduce a transparent incentive on Transco, in addition to the regulatory and gas transporter licence obligations, to ensure it seeks to complete the required connection works at new Aggregate System Entry Points by the agreed delivery date. Under the Proposal, Transco would suffer loss of revenue under the Entry Capacity Investment Incentive for each gas day for which it is not able to accept gas properly tendered for delivery. Consequently, for this period, Transco would suffer a loss of income that is commensurate with its broad estimate of providing the capacity (on an annuitised basis) and a rate of return of 6.25%. Transco considers that

the amount of recompense under the Proposal is reasonable as it aligns potential risk (to Transco) to potential rewards (to Transco).

Transco believes that it as a principle of the Network Code that consequential losses are excluded. To do otherwise would require a reassessment of risk mitigation procedures and rewards commensurate with the heightened risk. Transco considers that provided there is a sufficient incentive on Transco to complete works in a timely manner; which Transco considers this Proposal and existing regulatory and gas transporter licence requirements provide, then a User's consequential loss should not be a factor in the Network Code. Transco considers that it would be unreasonable for it to be exposed to costs that it could not confirm was reasonably incurred, that it may not be aware of, and which it could not control. Transco also considers that the level of risk described in this Proposal is commensurate with the lead times for delivery of Incremental obligated Entry Capacity as described in its Incremental Entry Capacity Release statement. Transco considers, therefore, that compensation to Users should not extend beyond that detailed in the Proposal.

11.2 Alternative Proposals

SSE believed that the Proposal should be considered as a "useful starting point" and pointed out "that there would be nothing preventing Users proposing other arrangements which could build on this at any point in future." It acknowledged concerns that the level of compensation may not be sufficient to cover individual Users in each case and proposed that "the most appropriate mechanism for dealing with such detail should be under contract or agreement."

Stat commented that it may be "appropriate to create a different mechanism to determine the costs associated with non-delivery of new capacity."

EXX concluded that Transco should "supplement their initial proposal with one …… providing liquidated damages which approximates some proportion of the estimated loss likely to arise to Users……..." A "daily capacity "underrun" " was suggested with Transco paying Users "some multiple of the price of the capacity that has been allocated but which cannot be used." A multiplier of eight was suggested as this could be compared to overrun arrangements. EXX recognised that the costs to Transco must be bearable "in terms of its financial status as a regulated entity, and be consistent with the reward that it stands to earn under the terms of its regulation."

BGT believed that as Users would need to source alternative gas supplies if access to new capacity was not available there would be a "parallel with the concept of capacity buy-backs at existing terminals." BGT considered that Transco's exposure to extreme buy-back costs could be mitigated. Obligations could be passed on through provisions within Transco's procurement contracts and consideration could be given to Transco applying for an "Income Adjusting Event" under its Licence. BGT also suggested "there would be scope for some regulatory oversight of the process, which would ensure that no party is able to take advantage of Transco as a distressed buyer."

Transco Response

Transco notes the suggestion that stand-alone agreements could be used. As Transco contracts for entry capacity with Users through the Network Code, Transco considers that the Network Code would be the

most appropriate place for resolution of any issues arising and therefore disagrees with the proposal for separate agreements. However, Transco does have limited stand-alone agreements relating to new ASEPs, but these are generally with the project developers who will not be Network Code signatories (or will be acting other than as a signatory). Within these agreements, Transco makes a commitment to provide liquidated damages, but this would relate solely to the completion of construction works for provision of the connection, which is an activity not covered contractually by Network Code.

EXX suggested that a liquidated damages payment should be made that would relate to likely costs. Transco notes the proposal by EXX of a capacity "underrun" methodology that would be analogous to capacity overrun charges. However, Transco does not consider that this proposal provides a link to actual losses that EXX suggests is required. The proposal is therefore arbitrary and, in Transco's opinion, a multiplier of eight as applied in the overrun methodology would be punitive.

Transco considers that it would be inappropriate to make an analogy between late provision of entry capacity at new ASEPs and overrun charges. Overrun charges are intended to incentivise Users to make appropriate capacity bookings to provide an indication of gas flow intentions and are applied over a short duration.

Transco welcomes the recognition by EXX that, if the high penalties that it suggested were to be implemented, then Transco would need adequate funding.

Transco considers that a capacity buy-back methodology, as suggested by BGT, would not be appropriate for new ASEPs. As late provision of entry capacity at new ASEPs would require Transco to buy-back all of the allocated capacity Transco would become a distressed buyer. BGT suggested that Transco could receive additional funding to balance the additional extreme costs. It is not clear how the level of such funding could be arrived at and Transco would expect the appropriate licence changes to be agreed before implementation of any Network Code Modification Proposal.

The possibility of “regulatory oversight” conveys that Ofgem should have a policing role in such a regime to prevent Users taking advantage of Transco's distressed buyer position. Transco does not believe that this is appropriate or practical and would require clear definition before a Network Code Modification could be implemented.

BGT also suggested that Transco could mitigate its risk by passing obligations on to its contractors. Transco agrees that its contractors have some control of project delivery schedules and it may therefore be appropriate to back-off, where possible, the incentive. However, Transco is of the opinion that this would have an adverse effect on such projects. It is likely that construction costs would increase substantially as contractors would attempt to insure their liabilities and fewer contractors would be willing to undertake the works. Contractors would also be less willing to commit to challenging timescales, potentially resulting in longer initial construction programmes.

11.3 Process

SP questioned the process and timing for this Proposal believing that it had “proceeded to consultation on the basis that there would be further discussion in a number of related areas, with the possibility of a supplementary modification.” It further believed that “this is unlikely to become an operational issue

for some time yet" thereby would allow time for issues to be "further explored" and that it would not be necessary to implement a solution at this stage.

Transco Response

This Proposal was presented to the NT&T Workstream in December 2003. The Workstream considered that the Proposal did not need further development and that it should proceed to consultation. However, it was recognised that alternatives may be developed by the industry in due course.

Transco agrees that it will be some time (several years) before any payments may become necessary under this or any alternative proposal. However, Transco is aware of projects currently being developed where reassurance is required by the project backers that there would be sufficient incentive on Transco to minimise the risk of late availability of entry capacity at new ASEPs. This reassurance, it is claimed, is required urgently to facilitate participation in LTSEC auctions and to agree to preliminary works. Transco considers that implementation of this Proposal would provide such reassurance in that it provides for an appropriate loss to Transco in the event that capacity is not available by the agreed delivery date.

11.4 Legal Text

BGT did not understand why the Proposal was limited to apply only to Quarterly System Entry Capacity when under current arrangements Monthly System Entry Capacity (MSEC) can be purchased up to two years in advance.

EXX have qualified its support for the Proposal by making it subject to amendment of the legal text which had stated that the arrangements in the Proposal should be the sole and exclusive remedy. EXX's support "depends on Transco acceptance that this is the first element of the appropriate remedy".

Transco Response

Transco may release entry capacity at a proposed new Aggregate System Entry Point following adequate signals from LTSEC auctions. Only quarterly entry capacity is allocated following LTSEC auctions. As Transco's investment decisions are made partly upon the outcome of these auctions, Transco considers it to be appropriate that any recompense for late delivery of entry capacity is made to Users allocated capacity from these auctions.

Transco contracts with Users for capacity through the Network Code. It is appropriate, therefore, that any redress for late provision of the capacity would also be covered by, and limited to, Network Code provisions. The proposed legal text would not prevent supplementary Network Code proposals being introduced at a later date.

11.5 Scope of "Works"

Edf expressed concern that the Proposal "does not address circumstances whereby upstream third party works have not been completed to allow the physical flow of gas." They hoped that "Transco will have the appropriate contracts".

EXX believed that Transco could accept arrangements in addition to those of this Proposal, as Transco could minimise its risk as it "is free to enter into pre works agreements funded by developers". These would provide a "buffer against the risk of later delays in major works".

Transco Response

The Proposal is intended to incentivise Transco to complete its works by agreed delivery dates. Upstream third party works are those works provided by, or on behalf of, the developer of a new entry or storage facility. These third party works connect Transco's System (as may be extended by any Transco works) to the new facilities. As Transco would have allocated entry capacity and, if this Proposal is implemented, committed to a loss if gas cannot be accepted when properly tendered for delivery, then it would be unreasonable for Transco to suffer that loss if the reason for non-acceptance was the late completion of upstream works over which Transco had no control.

Transco agrees that the likelihood of capacity being provided late can be reduced by entering agreements to undertake preliminary works. These works, funded by the developer (but refunded if an appropriate auction signal is received) would allow Transco to keep projects to schedule until Users participate in the auction process. However, it would be incumbent upon Users to participate in the auction as early as possible as preliminary works offer a limited "buffer" and developers may be reluctant to commit to arrangements for preliminary works.

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

Implementation of the Proposal is not required to facilitate 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

Implementation is not required having regard to any proposed change as detailed above.

14. Programme of works required as a consequence of implementing the ModificationProposal

A programme of works will not be required to implement the Proposal.

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

Transco would propose immediate implementation following Ofgem's direction.

16. Recommendation concerning the implementation of the Modification Proposal

Transco proposes implementation of the 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

Draft Legal Text

SECTION B

Amend paragraph 2.11.1 as follows:

"2.11.1 (a) A User shall, subject to paragraph (b) below, pay Capacity Charges . . . at Aggregate System Entry Points.

(b) Where:

(i) pursuant to paragraph 2.2.18 Transco allocates Quarterly System Entry Capacity for the first time at a New Aggregate System Entry Point from a specific date (the "**First Capacity Allocation Date**") but fails to accept gas properly tendered for delivery by a User (for the purpose of this paragraph 2.11.1 a "**relevant User**") at that Aggregate System Entry Point in the period on and following that First Capacity Allocation Date; and

(ii) the reason for such failure is the non commissioning of that Aggregate System Entry Point or any System Entry Point comprised within it; and

(iii) the relevant User both holds Registered Quarterly System Entry Capacity and does properly tender gas for delivery on the relevant Day(s) at that Aggregate System Entry Point,

then no System Entry Capacity Charges shall be payable by that relevant User in respect of such Registered System Entry Capacity at that Aggregate System Entry Point for each Day in the period from the First Capacity Allocation Date to the Day immediately preceding that on which Transco is first able to accept gas properly tendered for delivery by any User. Notwithstanding any other provision of the Code, the provisions of this paragraph (b) shall be the sole and exclusive remedy of Users where Transco fails to accept gas properly tendered for delivery in the circumstances set out above.

Signed for and on behalf of Transco.

Signature:

Mike Calviou
Head of Commercial Frameworks
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 **0680**, version **1.0** dated **12/03/2004**) 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 **1.0**.

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 appropriate

   provided 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.