URGENT Modification Report
Recompense in the Event of Late Completion of Works for New Entry Point Capacity
Modification Reference Number 0682

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

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

1. The Modification Proposal

The Proposer states that:

"This Modification is designed to apply where Transco have allocated Long Term System Entry Capacity following a decision to physically construct such System Entry Capacity in relation to a new System Entry Point.

The proposal states that when an LTSEC Auction allocation has triggered a physical network extension and connection to provide such entry capacity, Transco enter into a Capacity Management Agreement in accordance with Section B 2.8 of the Network Code (v3.0) with those incremental Registered Users.

In the case of new System Entry Points a Capacity Management Agreement is generated automatically, so providing Transco the ability to both signal and manage any constraints due to late completion of works whilst providing the Registered Users with defined compensation rights that represent a proportion of the losses likely to arise to each such User and which could be viewed as a suitable incentive for timely completion of the works. The need for such compensation at new entry points was identified in Ofgem's views on Transco's proposals on New Entry terminals to Transco's National Transmission system, June 2003.

Such Capacity Management Agreement would terminate when Transco works for expansion are completed. Transco would not be able to use this agreement for any other capacity management purposes (eg selling incremental capacity at a higher price to WDF bidders) and such agreement would terminate on the 1st anniversary of the Capacity Allocation date.

BG recognises Transco's concerns that daily capacity buyback could result in Transco being exposed to the maximum buy back prices permitted under RGTA / Gemini systems, and our proposal is that for the first 12 months of any delay, Transco's daily exposure would be pre-set.

BG propose that all the capacity allocated would be available to be surrendered to Transco, and the daily offer price would be set at 8 (eight) times the relevant Quarterly auction capacity allocated bid price. We propose that this would also be subject to a further cap to the level of the expected losses or costs caused to the shipper by the delay in provision of capacity. This multiplier provides an effective incentive to Transco to complete the works on time, and is related to the level that Shippers have to pay for flowing gas against insufficient entry capacity holdings (Section B2.12.3.a).

In the event that Transco's works were not completed within 12 months of the Capacity Allocation Date, then the Capacity Management Agreement would be terminated and normal capacity management tools would be available to Transco. This would potentially increase the exposure that Transco faced."

2. Transco's Opinion

Transco does not support implementation of the proposal.

Transco recognises that in the event that it is late in making capacity available at 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 new 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 covers many of the issues of respondents in Section 11 of this report, but in summary Transco does not support this Modification Proposal because:

In general terms Transco considers that the approach taken by this proposal is outside the scope of its business in terms of risk and reward. The risks are not coincident with the rewards and rate of return that Transco receives for releasing capacity. The proposed liabilities are not cost reflective. Transco has little control over scope of work or timescales, which are customer driven and where many of the reasons for delay are outside our control e.g. planning delays, so the proposed liabilities are inappropriate.

However, if such an approach were to be considered then Transco would expect this to take place as part of a wider review of its regulatory framework particularly with repsect to its incentive structure such that the rates of return of release of capacity and the funding of its incentive scheme reflected the risk it would face from potentially increased liabilities and increased costs by backing-off risk through, for instance, its construction contracts with developers.

In terms of detail Tranco does not support this proposal because:

- the link to overrun charges is inappropriate because overrun charges are designed to incentivise Users to make appropriate capacity bookings to provide an indication of gas flow intentions and are applied over short periods. The mitigation to the risk placed upon Users is to book additional entry capacity or flow less gas. This is not analogous to providing Entry Capacity at new entry points where the risk is based upon scale, scope of works and timescales required to provide a physical connection.
- Transco considers that management of such additional risk would have to be handled by placing additional liabilities onto the construction companies which could result in them inflating costs and potentially extending construction lead times.
- There is also a limited pool of willing construction companies could be further reduced by any manifestation of additional risk. An alternative approach is that Transco could seek to extend lead times for providing new entry capacity in circumstances where construction risk could appear to be particularly onerous which is in no-ones interest.
- Liabilities are proposed to be capped at actual costs and losses – these will be difficult to verify and it is not clear what costs or losses are expected to be included therefore the precise nature of the required legal text is uncertain.
- Transco presumes that the proposed new Capacity Management Agreement would count towards the System Operator buy-back incentive which has targets that have been set without any consideration of the proposed category of agreement. Transco believes that prior to implementation the Incentive target would need to be re-considered.
- On a number of points of detail the proposer has not clarified what (non-price) terms should apply to the Capacity Management Agreement. Also it is not clear how the Capacity Management Agreements would be generated "automatically" for each Registered User. This will hamper the satisfactory drafting of legal text.

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 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 System Entry Points would further the economic and efficient operation of the transportation system.

However, Transco is concerned that the proposal would subject Transco and Users to an unacceptable level of risk of extreme liabilities, where many delays to projects would be outside Transco's control e.g. planning delays, that would be shared through Transco's System Operator Buy-Back Incentive scheme. This could ultimately be reflected in increased transportation charges and therefore may be deemed ultimately to be neither economic nor efficient. Also, Transco would be incentivised to back-off some of its risk either through its construction contracts with contractors, who in turn would no doubt wish to insure their liabilities. Therefore fewer contractors would be willing to undertake works or willing to commit to challenging timescales, resulting in longer initial construction programmes – clearly not an efficient outcome.

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

a) implications for the operation of the System:

There are no implications for the physical 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.

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 considers that costs will be recovered through Transco's System Operator Buy-Back Incentive.

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

Although it is not anticipated that there would be any impact on price regulation per se any increases in costs as a result of this proposal would flow through the System Operator Buy-Back Incentive and would be recovered ultimately through increased transportation charges.

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 System Operator Buy-Back Incentive.

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

Systems development would be required to enable calculation of costs depending on the length of delay, the price of the allocated bid, buy-back costs and a cap on liabilities, with payments ultimately reflected on a Users invoice. If the proposal were to be implemented the additional costs would also have to be factored into the cash flows of the System Operator Buy-Back Incentive.

7. The implications of implementing the Modification Proposal for Users

Transco believes that Users would be faced with increased risk of exposure to extreme liabilities generated by costs that could accrue to the System Operator Buy-Back Incentive.

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

Non-Network parties could be affected. Transco may be able to mitigate its risk by passing obligations on to its contractors. Although Transco agrees that it is it's contractors that have control of project delivery schedules, so it would be appropriate to back-off, where possible, exposure, it is Transco's opinion that this would have an adverse effect on such projects. It is likely that construction costs would increase substantially as contractors attempt to insure their liabilities and fewer contractors are willing to undertake the works. Contractors would also be less willing to commit to challenging timescales, resulting in longer initial construction programmes.

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

Advantages:
Transco believes that implementation of the proposal would provide an incentive for Transco to ensure timely completion of connections between new entry points and the transmission system.
Disadvantages:
Transco believes that the proposed level of payments is not proportionate to the allowed level of reward available to it for providing Incremental Entry Capacity.
The opportunities available to Transco for risk mitigation are limited and could broadly result in longer lead times for providing new Entry Capacity. Arbitrary levels of liability are specified with a cap on losses that is indeterminate.

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

Representations have been received from:

Respondent	Response
BG Gas Services (BGS)	For
British GasTrading (BGT)	For
Dragon LNG (DLNG)	For
EDF Energy (EDF)	For
ExxonMobil (EXX)	For
RWE Innogy (INN)	For
Powergen (PGEN)	For

Shell Gas Direct (SGD)	For
Scottish & Southern (SSE)	For
Statoil UK (STUK)	For
Total Gas & Power (TGP)	Against
Total E&P (TEP)	Against

SSE qualify their support in stating that if it is believed that there are issues raised in Modification Proposal 0682 which require more detailed consideration or debate then it would be appropriate to proceed with implementation of modification proposal 0680, at least as an interim measure.

EDF also qualify their support expressing concern over the methodology for establishing a cap on losses.

11.1 General Principles

BGS supports the proposal because they envisage that the costs would hit Transco directly and that the proposal is sufficient incentive to complete works on time. BGS explain that no-one is intended to win from this proposal, Transco and Shippers will face losses and the UK is potentially exposed to a shortfall in gas supplies.

BGT are in favour of the proposal and support the introduction of a mechanism which compensates Users when Aggregate System Entry Capacity is not available. BGT believes that the proposal addresses the reservations of Modification Proposal 0680.

DLNG are in favour of the proposal and keep their response to general principles. They state that without appropriate incentives/controls on Transco, developers and investors will be unable to assemble the supply chains and contract chains necessary to allow LNG and other such new supply projects to proceed and be financed. DLNG do not believe that Modification Proposal 0680 begins to address the issues and would result in shippers receiving no compensation for their potentially large economic loss.

DLNG go on to explain some typical commercial arrangements based on liquidated damages where for example fixed amounts of LDs are paid for each day of delay in a project's completion, up to a limit. Provided that the LDs are paid when due, the delaying or non-performing party is not in default under its contract until a certain end-date has been reached. In this way the risk is shared, the ultimate liability of each party is known, incentives to perform are provided and the risk of open-ended litigation is controlled.

EDF offer support for the proposal but qualify this with concerns over the methodology to establish a cap on losses and that it does not address circumstances whereby upstream third party works have not been completed to allow the physical flow of gas.

EXX support the proposal and recommend an early Ofgem decision on the proposal and think there may be some merit in reviewing the IECR in the context of GB oversupply.

INN supports the principle behind this modification and establishing Capacity Management Agreements seems a neat way to signal and manage constraints due to late completion of works and that the agreements should terminate on completion for the works or at a pre-defined date.

PGEN support the proposal stating that under the current arrangements there is no protection in place for booking entry capacity at New Entry Points and that modification proposal 0680 does not provide sufficient compensation for Users.

SGD support the proposal and whilst also supporting Modification Proposal 0680 believes that this is a better approach and a more suitable incentive mechanism.

SSE supports the proposal and believes it is essential that appropriate mechanisms are put in place to incentivise Transco to complete works and deliver new entry capacity and to ensure that appropriate levels of compensation are paid to Users where this is not achieved.

STUK supports the proposal as it will provide a clear signal to Transco to complete the required work on time or face the financial consequences.

TGP and TEP were against the proposal - TGP/TEP believe that the proposal would not only penalize Transco for late completion of works but (also) the entire shipping community. TGP/TEP did however support the principle that Transco should have a strong financial incentive to ensure that capacity is built within timescales. TGP/TEP hopes that a proposal is raised that hits Transco's bottom line but does not have a financial impact on shippers.

Transco Response

Transco agrees with the general principle of the proposal which is similar in nature to modification Proposal 0680. However, Transco does not agree that the potential level of exposure in this proposal for both Transco and Users is proportionate or reflective of Transco's costs incurred. Transco believes that the proposal puts an unacceptable level of risk on Transco without specifying how such risks could be readily mitigated. If implemented Transco is of the opinion that the potential risk mitigation routes would need to be explored. Transco is also of the opinion that the proposal could not be implemented because of the imprecise specification of the cap on losses which poses a significant challenge for providing suitable legal text.

11.2 12 months of pre-set Transco's daily exposure

BGS explain that the 12 months of pre-set exposure is designed to provide some comfort to Transco in the event of a short term delay.

BGT state that the period of 12 months does facilitate a transitional period where Transco is relieved from the full impact of buy-back exposure.

EXX believe the one year period is reasonable to allow Transco some protection against events outside its control. Also that the daily exposure has merit in being transparent.

INN believe that during the period the Capacity Management Agreement is in place the compensation payments should resemble the structure that is in place for entry capacity overruns.

SGD consider that the buy back mechanism used for existing entry points may not be appropriate initially for new entry points.

STUK are supportive of Transco entering into an agreement to effectively buy back the capacity at a predetermined price.

Transco Response

Transco agrees that a time limit should be set on the period of exposure to the proposed charges. Transco would prefer that the established Network Code Capacity Management process should take effect soon after gas has first flowed through the pipeline. That is after a successful physical connection has been demonstrated. Transco does not see how linking payments to "expected" losses can be transparent.

11.3 Daily offer price set at eight times the relevant quarterly auction capacity allocated bid price

BGS explain that this has symmetry with the over-run regime introduced under Modification 500 where a shipper bringing gas into the Network without sufficient entry capacity faces the same multiplier. BGS draw parallels with Modifications 589 and 653 which proposed reducing this level and which were not supported by Transco.

BGT state that the interim rate of eight times may be considered somewhat arbitrary it does align with the existing regime for overruns, which could be seen as a proxy for use of capacity that is not available and that it appears to represent a reasonable measure in the absence of a market driven rate

EXX believe that any kind of multiplier could be viewed as arbitrary because Users' losses tend to relate to the price of re-balancing gas. Also that the multiplier would seem sufficient from a lenders point of view.

INN believe that the payment regime should be subtly changed so that shippers should be entitled to make offers to surrender capacity to Transco or enter into forwards/options contracts but that these offers should reflect the costs incurred by the shipper as a result of the capacity not being available. A cap should be applied to these payment levels equivalent to eight times the relevant average capacity bid price.

SGD believe that the proposal based on a multiplier of the price at which the capacity was sold more closely replicates what would be expected at an existing terminal.

SSE believe that the proposal strikes a reasonable and more equitable balance between the level of costs likely to be incurred by Users whilst providing reasonable incentive for Transco to complete works on time.

STUK state that the 8 times multiplying factor may go someway to addressing potentially significant costs that result from a late connection.

Transco Response

Transco does not recognise any link to overrun charges as these charges are designed to incentivise capacity booking at existing entry points and are applied over short periods. They can also be readily avoided by booking new entry capacity, a situation that is not analogous to new entry points.

Transco agrees with those that state that the multiplier of eight times the relevant quarterly auction capacity allocated bid price could appear to be somewhat arbitrary. In addition Transco cannot see how any multiplier would be related to the contractual losses suffered by Users who were not able to make use of the available capacity.

11.4 Further cap to the level of the expected losses or costs caused to the shipper by the delay in provision of capacity

BGS explain that the 8* multiplier does not cover the expected losses to shippers of a delay to transportation capacity being available but accept the principle of such a provision.

BGT state that the further limitation of the costs or losses ensures no User would see a benefit arising from the delay.

EDF has concerns regarding the proposed cap in that the value of the cap may be difficult to calculate and that the methodology should be clarified sent out for industry consultation.

EXX support the cap on the level of compensation at the expected losses or costs in principle but are concerned that it may take time to conclude suitable arrangements and do not want this to unduly delay implementation of other parts of the proposal.

INN, in line with their comments in 11.3 believe that the cap could be lifted once the Capacity Management Agreement has terminated and believe that this structure could enable more imaginative market solutions to be developed.

Transco Response

Although Transco does not support implementation of a regime where there are unlimited liabilities Transco also agrees with those respondents that have concerns about having a cap on losses and the practicality of its implementation. It has not been made clear how such a cap would be arrived at and how it would be verified.

11.5 Capacity Management agreement to be terminated if works were not completed within 12 months of the capacity allocation date

BGS explain that after 12 months delay the agreement should be terminated and Transco would then face market based buyback offers and that this does not prevent Transco entering into additional forward contract arrangements.

EXX believe that 12 months is reasonable and Transco could seek to extend this through a Modification Proposal if necessary. EXX also add that it is their view that a Capacity Management Agreement can be effectively triggered when developers enter into material commitments ahead of LTSEC auctions.

INN state that it may be appropriate to apply a maximum duration to Capacity Management Agreements of only six months.

SSE believes that it is reasonable that the agreement should terminate automatically when works are complete and capacity delivered or on the first anniversary of the capacity allocation date.

STUK are concerned that the agreement would only continue for 1 year and then revert to the traditional capacity management procedures. Where no capacity has been made available at a new entry point Transco would not appear to be under any obligation to buy back capacity as there is no possibility of a shipper utilizing the capacity it has purchased, thus no constraint would be created. It may therefore be necessary to include measures that will continue until the connection is made rather than falling away after one year.

Transco Response

Transco does not agree that the established Buy-Back process could apply after 12-months if a physical connection has not previously been completed. This is the reason for considering Further Modification changes. If, however, a connection has been completed then Transco considers that the established Buy-Back process should apply from the date at which gas can properly be tendered for delivery.

11.6 Transco Incentives

BGS state that the costs would be borne by Transco rather than through the capacity neutrality mechanism.

BGT consider that existing arrangements for Transco's incentives should be revisited and that caps, collars and sharing factors should not dilute the incentive on Transco in making appropriate arrangements with their agents and contractors to ensure that the capacity is available on schedule.

SGD believe that should the proposal be accepted then a pricing proposal should be brought forward such that any compensation that Transco is liable to pay should be properly included within its SO incentives package, probably as part of the buy-back incentive.

TGP/TEP state that should the proposal be implemented shippers would be significantly exposed via smearing charges.

Transco Response

Not all respondents commented on this aspect of the proposal and it may be that respondents were unaware of its ramifications in this regard.

Transco agrees with those respondents which state that should the proposal be implemented Users would be exposed to changed costs and benefits arising from the System Operator Buy-Back Incentive.

11.7 Incremental Entry Capacity Release Methodology Statement

EXX are concerned that the IECR should be reviewed to include some qualification so that the IECR rules should not be interpreted narrowly to avoid exposure to any compensation incentives.

Transco Response

The provisions of the present IECR methodology with repsect to release of incremental capacity were developed at the time of a liability-free environment. If liabilities are introduced then it would be reasonable for Transco to give consideration to the interaction between lead times for delivery and risks associated with late delivery. This could result in changes to delivery times for incremental entry capacity.

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

Implementation is not required for this purpose.

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 such proposed change.

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

There would not be a significant programme of works.

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

Proposal agreed as urgent	24 February 2004
Circulate to Users requesting representations	27 February 2004
Representations close out	09 March 2004
Final Modification Report to Ofgem	12 March 2004
Ofgem decision expected	26 March 2004

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this 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 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:

Mike Calviou
Commercial Frameworks Manager
NT & T

Date: