Modification Report
Obligation on the shrinkage provider to acquire system entry capacity
Modification Reference Number 0594
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

The Proposer has stated that :

"Under current Network Code rules, the Shrinkage Provider is not required to apply or hold System Capacity or to pay capacity charges. NTS shrinkage, or own use of gas comprises four elements: unaccounted for energy, unbilled energy, system own use and fuel for electric compressors.

Transco has an incentive under its SO incentive schemes to manage NTS shrinkage costs efficiently. A separate incentive relating to LDZ shrinkage forms part of Transco's LDZ price controls. Customers pay the costs of shrinkage ultimately.

The current Network Code arrangements are inefficient and are inconsistent with Transco's licence obligation to operate an economic and efficient pipeline system and they distort Transco's incentives.

Under Transco's NTS SO incentive, Transco is set a volume target for the year and a target price to acquire shrinkage gas. The volume target for this formula year is 8,265GWh. The price target is 0.702p/kWh. Ofgem set this price target by applying a swing premium to the forward price at that time.

The shrinkage provider should, therefore, be required to hold system entry capacity and pay entry capacity (and if appropriate overrun charges) where appropriate. As the price was set on the basis of forward prices at the NBP (and not at the beach), it would have included an allowance associated with entry capacity costs. The reference price and existing incentive scheme therefore contains an allowance associated with entry capacity costs.

If Transco does not pay entry capacity costs, it will lead to payments under the incentive scheme that are not associated with efficiently procuring gas as Shrinkage Provider. It could also distort Transco's incentives to operate efficiently. Transco, when procuring shrinkage gas and utilizing existing contracts to procure gas, should face the total cost (including entry capacity costs).

This proposal merits urgent status. Transco will already have accrued 6 months of benefit under its SO incentive scheme because of an anomaly in the Network Code rules. Shippers need to be assured that Transco will, in managing shrinkage, have incentives to operate efficiently this winter. Annual shrinkage volumes for the current formula year are 8.2TWh and target costs are £60m. The value of the benefit of free capacity to Transco could, therefore, be very significant. The potential distortions and costs to shippers and customers associated with Transco bringing on gas for shrinkage purposes at constrained terminals (as Transco does not face the costs of entry capacity and may not, under the buy back incentive, be fully exposed to any resulting buy back costs) could also be significant. As the benefits are accruing daily, and the costs could escalate rapidly during a period of entry constraints, AEP believes that this proposal merits urgent status.

Although MSEC has already been sold this winter, Transco can purchase entry capacity for shrinkage purposes in secondary markets and/or RMSEC, DSEC and Interruptible auctions."

2. Transco's Opinion

Transco does not support implementation of this Modification Proposal.

Transco considers that its Licence obligations provide appropriate incentives to efficiently manage the procurement and operation of the Shrinkage Provider (SP) account. These incentives arise from the Licence conditions that define the LDZ price controls as well as the SO incentive arrangements, particularly the system balancing incentive.

Transco believes that the recently agreed modifications to its Gas Transporter (GT) Licence, that took effect from the 1st April 2002, were proposed by Ofgem on the basis of continuation of the existing Network Code terms relating to the operation of the SP account. Transco is not aware of any suggestion in Ofgem's consultation and proposal papers that a change to the arrangements was contemplated, and Transco's information provision regarding cost projections and subsequent acceptance of the Licence modification proposal was also on the basis of continuation of the existing Network Code terms. It is therefore Transco's view that implementation of this Modification Proposal would be inconsistent with the SP assumptions which underpin the Licence arrangements in respect of the LDZ price control and SO incentives.

Transco does not believe that implementation of this Modification Proposal would further the relevant objectives of the Network Code.

The SP has procured gas at both the beach and the NBP. The SP can bring gas onto the System without needing to hold System Entry Capacity. However when the SP has procured gas at the beach the contractual terms have provided Transco with flexibility to ensure that gas flows are removed from a beach terminal before capacity management tools are deployed close to gas flows. This reflects the business rules agreed with the community in July 1994 that have underpinned the Network Code and three successive Transco price control settlements. Thus Transco considers that the current Network Code terms, and the combination of operational procedures and procurement activities have ensured the economic, efficient and co-ordinated operation of the System.

Transco has already procured beach gas arrangements with the flexibility defined in the previous paragraph. Such arrangements currently ensure efficient gas flow management. Implementation of this Proposal might necessitate capacity purchases or capacity overuns where the SP sources gas prior to entry to the system and may excerbate entry constraints and costs due to loss of the flexibility afforded by the current arrangements.

Implementation of this Modification Proposal may increase the cost of SP account operation. Any additional costs for LDZ shrinkage procurement would be a direct cost to Transco. Under the NTS SO system balancing incentive scheme, additional costs incurred in the operation of the SP account would be borne predominately by Users. In addition, implementation of this Modification Proposal could have implications across other SO incentive schemes. In particular, Transco believes that implementation might increase the demand for capacity. Revenue from additional capacity sales could impact both the capacity buy-back incentive scheme and the entry investment incentive scheme, providing a financial benefit to Transco.

Transco has considered the possible interactions between the gas and electricity regimes and has concluded that there would be no impact on the electricity regime if this Modification Proposal was implemented.

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

The Proposer argues that implementation of this Modification would ensure that Transco would face the full commodity and entry capacity costs associated with procuring Shrinkage gas; this will lead to more efficient system operation thereby better facilitating the relevant objective of the efficient and economic operation of the pipeline system.

Transco does not accept the above position and has argued to the contrary in the above section of this report.

Transco therefore concludes that implementation of this Proposal would be inconsistent with the SP assumptions that underpin the Licence arrangements in respect of the LDZ price control and SO incentives. Furthermore implementation of the proposal might have a material impact in respect of incentives other than the System Balancing incentive. Transco therefore considers that implementation of this Proposal might not be consistent with the intent of the Licence.

Furthermore Transco does not believe that implementation of this Proposal would fulfill the relevant objectives of the Network Code. The current arrangements, in conjunction with the operational and contractual arrangements used by Transco deliver an efficient outcome. The requirement to purchase capacity would impact on capacity allocation processes and might create increased risks of prompt buy-back requirements. Transco concludes that this might have a modest, but adverse, impact on the economic and efficient operation of the System.

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

a) implications for the operation of the System:

Transco believes that the current arrangements provide for efficient flow management on the System when gas flows imply an imminent firm capacity shortfall. This arises because of the SP beach gas contractual terms which ensure the timely and precise quantity to be delivered at the chosen location. Implementation of this Modification Proposal would require Transco to procure System Entry Capacity (or face Overrun exposure) in respect of all gas delivered onto the System for the SP account. This might increase costs for the SP account and may influence the pattern of gas flows on the System. However, the precise impacts are uncertain since such requirements may exacerbate both the frequency and extent of the requirement for prompt buy-back actions or alternatively may actually generate incremental capacity purchases into which no gas flows.

On balance, Transco believes that implementation of this Modification Proposal is likely to detract from the economic and efficient operation of the System.

b) development and capital cost and operating cost implications:

Transco would not envisage any development or capital cost implications to arise. However Transco believes the intent of the Proposer is to increase the operating costs associated with the SP account.

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:

If the Proposal generates increased costs then these would be shared with Users in accordance with the relevant SO Incentive scheme in respect of NTS Shrinkage. Increased costs in respect of LDZ shrinkage would act to the detriment of LDZs.

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

Transco believes that implementation of this Modification Proposal would constitute a change to the assumptions underpinning the Licence modifications agreed during 2002. If implemented prior to the expected expiry of the current arrangements in March 2007, Transco believes it would be appropriate for modifications to be made to its Licence conditions in order to reflect the change from the assumptions used when the Licence was agreed.

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 currently has arrangements in place for beach gas deliveries for SP purchases for the 2003/4 formula year. Implementation of this Modification Proposal would therefore create an unanticipated requirement for capacity or define a requirement to renegotiate the terms of such purchases. This should be expected to increase financial risk for the SP.

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

No development issues are envisaged.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Modification Proposal might be expected to lead to changes in underlying costs and incentive performances. These may impact Users in accordance with the relevant SO incentive schemes as well as for those Users that have contracted with Transco to supply shrinkage gas.

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

No direct implications are envisaged.

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 is not aware of any impact on legislative and regulatory obligations.

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

Advantages:
The SP will be required to acquire entry capacity (or face overrun exposure where it procures gas for delivery into the system)

Disadvantages:
May lead to increased costs for both Shippers and Transco.
Seeks to change the basis of the System Balancing Incentive scheme, and indirectly other incentive schemes, which are set within Transco's GT Licence.
May lead to increased costs for LDZ shrinkage procurement
Transco would be required to either renegotiate beach gas trade deals already concluded or to secure entry capacity (and/or face overrun exposure) for such gas.

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

<u>Parties responding:</u>

AEP Energy Services Ltd (Proposer)

British Gas Trading Limited
LE Group
Scottish Power Energy Trading Limited
Shell Gas Direct Limited
Statoil (U.K.) Limited
TXU Europe Energy

The Proposer supported implementation for the reasons stated in the Proposal. All other respondents opposed implementation of the Proposal.

General

TXU and Statoil supported the principle underlying the Modifcation Proposal but were unsure it would achieve the desired result in the long term.

Transco's Response

Transco does not support implementation of this Modification Proposal as set out in this Modification Report.

Transco's GT Licence

Four of the respondents noted that Transco is incentivised to operate the SP account efficiently via conditions in the GT Licence. One respondent (SGD) noted that it did not consider it is no longer appropriate to effect material change to Transco's incentives through Network Code Modifications and that should change be seen as necessary then Ofgem should propose changes to the Licence. The Network Code could then be modified to ensure consistency with the Licence.

A second respondent (Scottish Power) felt that the current Licence conditions and incentives were not written in such a way as to make the proposed modifications workable. However the respondent further noted that there should be scope for amending the existing Licence conditions prior to 2007.

Transco's Response

Transco considers that its Licence obligations provide appropriate incentives to efficiently manage the procurement and operation of the Shrinkage Provider (SP) account. These incentives arise from the Licence conditions that define the LDZ price controls as well as the SO incentive arrangements, particularly the system balancing incentive.

Implementation of the Proposal within the current price control period might therefore be considered to be a change to the price control settlement. Transco would anticipate that, if so implemented, Ofgem might want to consider a Licence Modification to maintain similar incentive properties and similar distribution of risk sharing between Transco and Users.

Transco considers that as a general principle mid therm changes to the incentives defined in the Licence are inappropriate. This is particularly true when such changes are effected by a change in the Network Code. Transco therefore concludes that implementation of this Proposal would increase levels of regulatory uncertainty which might be damaging to the effective operation of the commercial regime.

Transco's Participation in Entry Capacity Auctions

With the exception of the Proposer all respondents raised concerns over the impact of Transco's participation in the entry capacity primary auctions should this Proposal be implemented. The concerns raised related to:

- The degree of change required across the industry to enable Transco to participate in an auction to buy a product for which it is also the counterparty.
- Potential distortions of the entry capacity market created by Transco's presence as both a buyer and seller.
- The creation of potentially perverse effects on Transco's Capacity Buyback & Entry Capacity investment incentives.
- The potential for increasing the occurrence of constraints and the deployment of capacity management tools, and
- Who would ultimately bear the burden of any increased costs arising out of making these changes to the regime.

Transco's Response

Transco notes the concerns raised by the respondents and anticipates that should this Proposal be implemented, Ofgem would monitor Transco's activity in respect of capacity purchases and its compliance with the Licence. However, Transco remains of the view that such a change is inappropriate at this stage and therefore Transco would oppose implementation of this Proposal during the current price control settlement period.

Review of Shrinkage Provider Account Operation

Although this Proposal did not receive support from the respondents, other than the Proposer, four of them (BGT, LE Group, SGD & TXU) noted that a full review of the operation of the shrinkage account and the role of the Shrinkage Provider should be undertaken. TXU contended that the SP should contract for gas on the same basis as shippers, either at the beach or the NBP. Two of the respondents (SGD & LE Group) felt that the review should be led by Ofgem whilst one (BGT) felt that the Shrinkage Forum would be an appropriate vehicle for it.

The response from LE Group also noted that whilst the preferred option would be to have a full, Ofgem led review of the shrinkage arrangements a possible alternative might be to discuss the issues raised in the Modification Proposal when the incentive parameters, which have been agreed in the Licence for the first two years, are reviewed.

Transco's Response

Transco considers that the current Licence, in the context of operational and contractual arrangements associated with the SP account facilitates the current Network Code rules and the efficient, economic and co-ordinated operation of the SP account and the system. Transco believes that alternative Licence and Network Code terms might, in conjunction with revised operational procedures and contracts be worthy of consideration to establish whether such arrangements might enable the SP account to be operated in a similar way to other accounts and afford the opportunity to improve the economic, efficient and co-ordinated operation of the system.

Transco would welcome a review of the shrinkage arrangements in order to faciliate full industry debate on the issues prior to the next price control review in 2007.   However, Transco would suggest that such changes might need to be agreed early in the current price control period to provide a high degree of regulatory certainty for both Transco and Users. Specifically if long term contractual arrangements are envisaged as part of the package that will enable delivery of an economic, efficient and co-ordinated outcome then it is essential an appropriate framework is agreed sufficiently early.

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

No such requirement exists in respect of the Modification Proposal.

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

No such requirement exists in respect of the Modification Proposal.

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

No specific programme of works is anticipated.

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

The development of an implementation timetable is subject to the Ofgem decision on the Proposal.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation.

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:

NT & T

Date: