Modification Report
Revisions to entry capacity overrun charges ahead of next auctions
Modification Reference Number 0589

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 current entry capacity overrun charges should be amended before the next set of MSEC auctions to remove the eight times multiple of monthly auction prices from the calculation and replace it with a multiple of 1.1 times the monthly auction prices. The other elements of the overrun calculation should remain unchanged.

The change to the overrun charge should take effect from 1 April 2003.

2. Transco's Opinion

Transco believes that maintaining an appropriate incentive on shippers to pre-book capacity is a necessary prerequisite to efficient management of the pipeline system. Capacity management provides the primary means of managing gas flow at entry and therefore its ability to manage gas flow could be impaired if the proportion of gas flowed against pre-booked capacity is diminished. Transco accepts that it is not plausible to predetermine a uniquely appropriate level for the overrun multiplier which should persist for all time, and that therefore periodic review in the light of experience is warranted.

Since 1 October 2002 an eight times multiplier has applied to the highest price paid for all firm entry capacity regardless of the primary release process (Quarterly, Monthly or Daily). Transco presumes that this proposal is intended to maintain the principle of applying a common multiple and that a literal interpretation of the proposal as applying to Monthly System Entry Capacity only is not what the proposer intended.

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

The proposer argues that this Modification Proposal "would better facilitate the relevant objectives by ensuring more efficient utilisation and operation of the pipeline system. By increasing incentives to trade and decreasing incentives to hoard capacity, it will lower capacity management and trading costs and prices".

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

a) implications for the operation of the System:

Provided that a sufficiently positive incentive to pre-book entry capacity is maintained there will be no implications for operation of the system.

b) development and capital cost and operating cost implications:

No such implications have been identified.

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:

No costs are anticipated.

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

No consequences are anticipated.

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 consequences are anticipated.

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

No implications have been identified.

7. The implications of implementing the Modification Proposal for Users

Users will be exposed to a lower level of overrun charge on days when capacity management costs are not driving the overrun charge calculation.

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

No implications are anticipated.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

No implications are anticipated.

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

Advantages

Overrun charge will be lower on 'non-constrained' days.

Disadvantages

May lower the incentive to pre-book capacity.

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

Summary of Representations:
Representation have been received from:

AEP Energy Services (AEP)
British Gas Trading (BGT)
Conoco UK (CON)
Entergy Koch (EKTL)
Innogy (INN)
London Electricity (LEG)
Powergen (POW)
Scottish Power (SP)
Shell Gas Direct (SGD)
SSE Energy (SSE)
Statoil UK (STUK)
TXU Europe (TXU)

Seven respondents (AEP, CON, EKTL, POW, SP, SSE, TXU) supported whilst five respondents (BGT, INN, LEG, SGD, STUK) did not support implementation of the proposal.

Whilst supporting the proposal SP expressed a concern that the proposal might not provide a sufficient incentive to guard against deliberately overrunning.

BGT argued that, “the purpose of an overrun charge is to provide a strong incentive for Users to hold capacity at the level of their maximum intended flows of gas entering the system. To do otherwise is in breach of licence obligations”. INN and STUK agreed that there should be strong incentives on Users to procure system entry capacity ahead of gas flow and INN also argued that as the overrunning User may be displacing gas that a User with pre-booked capacity is attempting to deliver, the overrun cost should send a strong signal not to. EKTL argued that any arrangements should be applied with a degree of good sense.

STUK observed that a diminished overrun rate could drive Transco to issue Terminal Flow Advice (TFA) notices to resolve capacity problems and concluded that a suitable incentive must be maintained for Users to pre-book capacity.

LEG does not support implementation of the proposal because it believes the proposal would completely undermine the need for any capacity auctions in the first instance. It argues that a 1.1 times multiplier would not be a fair reflection on the costs of overrunning on capacity. LEG continued Users are more likely to take the risk of overrunning and paying the penalty of 1.1 times the Applicable Daily Rate.

POW argued that at present overrun costs are higher than true costs and are therefore distorting true competition in the market. It also argued that a multiple of 1.1 better reflects true market costs, especially as the market does not always present competitive offers. SSE reminded that it has always believed in the principle that overrun charges should be cost reflective rather than arbitrarily penal. It also considers that the penal nature of the existing calculation has had a fundamental impact on the capacity regime by artificially inflating the auction price of capacity and stifling the secondary market. BGT accepts that an 8 times multiplier is arbitrary but argues that it is no less so than a 1.1 times multiplier.

TXU argued that a change to 8 times marginal price, as introduced by implementation of Modification Proposal 0500, was arbitrary and penal. TXU also observed that a number of sub clauses of the overrun calculation are Aggregate System Entry Point (ASEP) specific but that sub clause (a) is not explicit, though TXU observed that the ASEP specific nature can be inferred from other text in section B.

POW argued that cost reflectivity would better align the UK in readiness for the liberalising European market.

POW also argued that a multiplier of 1.1 would facilitate secondary trading in that overruns can occur which are outside a shipper's control, and the current high overrun charge impacts on a Users willingness to trade. EKTL argued that the present calculation may act to encourage Users to buy too much capacity in the primary markets as the risks of being short are extremely high, particularly if secondary market prices are supported by high overrun charges. EKTL and SP also argue a lower overrun multiplier would mean that Users are more willing to shape their needs through the secondary market rather than creating excessive demand for risk aversion purposes.

Con argues that the present overrun is harsh on non-constrained days.

SGD does not support implementation of the proposal but would support a further review of overrun charges. It argued that while there is a need to ensure that the overrun charges are not onerously high, it is also essential that they are not so low as to undermine the market for entry capacity either in the initial allocations or through secondary trading. Users should be encouraged to ensure that they have adequate entry capacity for their needs and to manage efficiently the risk of not having sufficient capacity.

INN suggested that it might be appropriate to review the overrun arrangements to consider whether the overrun cost could be set on an ex-ante rather than ex-post basis.

EKTL and SSE believe that the proposal should apply to all firm capacity. AEP is happy to clarify that the proposal is that a 1.1 times multiplier should apply to all categories of firm capacity.

Transco's response
Transco agrees with those respondents who have expressed concern that a 1.1 times multiplier might provide an insufficient commercial incentive to pre-book capacity. If the ticket to ride principle is undermined then Transco's ability to manage gas flow at entry through the established commercial arrangements could be impaired.

Transco recognises that the majority of respondents wish to maintain the ticket to ride principle and that it is difficult to determine a priori an appropriate multiplier that will maintain an incentive to pre book capacity, particularly on non constrained days. It is for these reasons that Transco believes that incremental change is preferable to precipitous change. Transco considers that a change from 8 to 1.1 times would be a signifcant change that could inadvertently undermine the ticket to ride principle, and that an intermediate step merits consideration were it concluded that a lower multiplier is appropriate.

Transco wishes to clarify that all elements of the overrun charge are calculated on an ASEP specific basis. Paragraph 2.12.1 of the Network Code stipulates "the User shall pay a charge ("System Entry Overrun Charge") in respect of System Entry Capacity at that Aggregate System Entry Point on that Day".

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

This proposal is not required in order to enable Transco 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

Not applicable.

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

A programme of works has not been identified.

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

Draft Modification Report issued	7 November 2002
Closeout for representations	28 November 2002
Final Modification Report issued	5 December 2002

Implementation is proposed to take effect from 1 April 2003

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that this proposal is not implemented.

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:

Tim Davis
Head of Regulation NT&T

Date: