Modification Report
Obligation on shrinkage provider to purchase gas at the NBP
Modification Reference Number 0599
Version 2.0

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 or commodity 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. 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 be required to hold system entry capacity and pay entry capacity (and 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.

In August, Transco raised modification proposal 0579 "Facilitation of Shrinkage Provide to make NBP Trade Disposals". This proposal would, if implemented, allow the Shrinkage Provider to dispose of gas at the NBP. Transco argue that this would improve the economic and efficient operation of the pipeline system by increasing the ability of the Shrinkage Provide to manage imbalance risk. This modification would, if implemented, exacerbate the problem identified. Transco would be able, as shrinkage provider, to procure gas at the beach and then sell it at the NBP without incurring any entry or commodity charges. This would allow Transco to buy gas at the beach and sell at the NBP profitably by avoiding charges. It would be very difficult for shippers and Ofgem to effectively police Transco's conduct to ensure that this was not occurring at the margin.

AEP Energy Services recently raised modification proposal 0594 "Obligation on the shrinkage provider to acquire system entry capacity. At recent workstream discussions, concern was expressed about the proposed modification and it was agreed that it needed further development. Shippers expressed concern about potential conflicts of interest given Transco's role in selling entry capacity. Further development will inevitably slow the date at which this modification could be implemented.

AEP continue to believe that this issue needs urgent resolution. The current arrangements are inefficient and are inconsistent with the intent of Ofgem's incentive arrangements. Ofgem, in setting Transco's SO incentives gave Transco an allowance for acquiring shrinkage gas based on NBP prices. Transco is able, under the current rules, to acquire gas without incurring any capacity or commodity charges. Transco will therefore benefit under its incentive regime as a result of the current rules and not as a result of any efficiency improvements in acquiring shrinkage. Shippers and customers will pay for these windfall gains to Transco. Transco has already accrued 7 months of benefit under its SO incentive scheme. 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.

AEP has therefore suggested another modification that can be implemented quickly whilst the industry and customers consider more enduring solutions to the problem identified. This modification would only allow Transco, as shrinkage provider, to take delivery of gas at the NBP. As Transco would be acquiring gas at the NBP, the price would reflect entry capacity and commodity costs incurred by the shipper selling the gas to Transco. This would ensure that Transco's incentives operate as intended but would not require Transco to acquire system entry capacity.

Transco, as shrinkage provider, would continue to enjoy flexibility in determining how it procures shrinkage gas but wherever it acquires gas for shrinkage purposes, delivery would be deemed to be at the NBP (even if Transco specified the delivery point as part of any agreement).

To the extent that Transco has contracts in place for the purchase of gas for shrinkage purposes, Transco would have to re-negotiate these arrangements so that any gas delivered was deemed to be delivered at the NBP. The seller would then become responsible for any relevant charges and would be likely to seek to recover these additional costs from Transco in any re-negotiation."

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 been enshrined within 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 and might be expected to, achieve the economic, efficient and co-ordinated operation of the System.

Transco does not believe that this Modification Proposal would better promote economic and efficient operation of the System. Implementation of this Proposal would further increase the demand for capacity, potentially exacerbating the risks of constraints that require capacity management tool deployment close to gas flow. Thus the proposed restriction in the SP arrangements might be expected to reduce the efficient outcome that the combination of Transco's contractual terms and operational procedures deliver to the community.

Transco also believes that implementation of this Modification Proposal could prove to be damaging to competition between Shippers. Transco would prefer to be able to honour contractual commitments made with counterparties. Implementation of Modification Proposals such as this could undermine the confidence of market players. To date Transco has already procured, from a number of Users, a proportion of the SP requirement for the 2003/4 formula year. Some of this gas has been procured at the beach, under terms that Transco believes, as explained earlier in this report, ensure that such purchases must be considered consistent with the economic, efficient and co-ordinated operation of the System. Implementation of this Modification Proposal would be inconsistent with the terms of those trades. Transco would therefore be forced to renegotiate those trades because of the change to the Network Code. Transco believes that implementation of this Modification Proposal would therefore undermine User confidence in transacting with Transco thereby undermining competition between Shippers in respect of the provision of services to

Transco. Furthermore, the increased risks, to Users, posed by such contractual changes may lead to increased costs for future contract arrangements with Transco.

Transco also believes that implementation of this Modification Proposal would be inconsistent with the intent of the recent Licence modifications that were designed to allow Transco commercial freedom to respond to the various SO incentive schemes and other obligations. This Modification Proposal specifically seeks to limit the SP procurement of gas to the NBP. This limits SP activity so that outcomes arising from the procurement of beach gas would not be permitted regardless of whether this is the most economic and efficient approach. Transco believes that such artificial constraints on its approach to purchasing would not be in the interests of customers, which Ofgem sought to align with Transco's interests through the structure of the SO incentive schemes.

Implementation of this Modification Proposal may increase the cost of SP gas procurement. 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 procurement of NTS Shrinkage would be shared with Users in accordance with the relevant incentive arrangements. 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.

Transco notes that it has been suggested by the Proposer that, if implemented, the Proposal would strengthen the incentives on Transco to operate the SP account more efficiently. Transco's view is that restricting the available options would not be expected to improve efficiency of SP account operation.

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.

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 relevant location. Implementation of this Modification Proposal would require Users who might possibly have supplied gas to the SP prior to such gas entering the system to procure System Entry Capacity (or face Overrun exposure) in respect of all gas delivered for the purpose of title transfer to the SP at the NBP. This would increase costs for such Users 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 decrease certainty about the location and timing of gas flows on the System and so might be expected to have modest adverse consequences for the 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:

Some of the possible increased costs may be shared with Users in accordance with the relevant SO Incentive scheme. Other increased costs would act to the detriment of Transco's LDZ performance.

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 significant change in assumptions.

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 inconsistency between those arrangements and the Network Code.

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

No development issues are envisaged. Transco is not aware of any implications that implementation of this Proposal might have for the related computer systems of Users.

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.

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: (Identified by Proposer)

By exposing Transco to the full costs of Shrinkage Procurement the Proposer believes that Transco will be more strongly incentivised to operate the Shrinkage Provider account more efficiently.

Disadvantages:

May lead to increased costs for both Shippers and Transco.

Seeks to change the basis of the System Balancing Incentive scheme which is set within Transco's GT Licence.

Creates a requirement to renegotiate beach gas trade deals.

May seek to undermine User confidence in transacting with Transco in the light of regulatory uncertainty.

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

Transco has received representations from six parties (other than the Proposer) expressing the opinions listed below on this Modification Proposal.

Parties responding:	Opinion:
AEP Energy Services Ltd (Proposer)	For
British Gas Trading Limited	Against
LE Group	Qualified support
Scottish Power Energy Trading Limited	Against
Shell Gas Direct Limited	Against
Statoil (U.K.) Limited	Qualified support
TXU Europe Energy	For

General

Three of the respondents opposed this Modification Proposal. Two respondents offered this Modification Proposal qualified support on the grounds that Transco should transact for gas on the same terms as other System Users although both respondents recognised that several issues would need to be addressed if this Proposal was implemented. AEP are in support as set out in the Modification Proposal, as are TXU as an interim solution pending a review of the shrinkage arrangements and the implementation of a more 'holistic' solution.

Transco's GT Licence

Four of the respondents noted that Transco is incentivised to operate the shrinkage account efficiently via conditions in the GT Licence. One respondent (SGD) noted that it does not consider it is appropriate to effect material change to Transco's incentives through Network Code Modifications and that should change be seen as necessary then Ofgem would be expected to propose changes to the Licence either now or as part of the planned review of the incentives in 2004. 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. Transco therefore agrees with SGD that changes to the SP incentive arrangements through the Network Code are inappropriate and any such changes contemplated might be better considered as an amendment of Licence conditions. Furthermore Transco considers that the current incentive arrangements were agreed in the context of the shrinkage regime defined in the Network Code and any subsequent changes which seek to amend these rules should be carefully considered in the context of how they contribute to efficient operation., given

that such changes may exacerbate industry stakeholder concerns about regulatory uncertainty which may be damaging competition.
Transco believes that Licence condition changes with regard to incentives prior to 2007 are unlikely to be appropriate as this increases regulatory risk and undermines incentive performance. Transco believes that Licence condition changes should only be contemplated where current arrangements are demonstrated to be inadequate. Transco believes that the current Licence conditions, SP procurement activity, Network Code rules and Operational Procedures deliver efficient outcomes and face erosion by the Network Code changes advocated in this Proposal which are inappropriate.

Commercial Issues

The respondents raised a number of commercial issues associated with the implementation of this Modification Proposal. The issues raised were;

- Two respondents (BGT & Scottish Power) commented that Transco as Shrinkage Provider is incentivised to operate the shrinkage account in an efficient and economic manner and, as such, both respondents believe that it is for Transco to determine the most appropriate method of acquiring quantities of shrinkage gas. Therefore, the respondents could not support the imposition of an obligation on Transco to procure gas for shrinkage purposes in a specific manner, as proposed in this Modification Proposal.
- Shell Gas Direct commented that this Modification could undermine effective competition between Shippers by undermining confidence in the market that contracts with Transco would remain in place without the need to renegotiate terms within the lifetime of the contract. Contract re-negotiations could potentially create significant costs which could feed into the prices offered by suppliers to the Shrinkage Provider thereby increasing Transco's costs and undermining efficiency. The complexity of any contract re-negotiation that might occur as a result of this Modification was recognised in the response from LE Group however, this respondent felt this would not negate the need to address the issues surrounding the procurement of shrinkage gas.

Transco's Response

Transco believes that implementation of this Modification Proposal could prove to be damaging to competition between Shippers. Transco would prefer to be able to honour contractual commitments made with counterparties as any renegotiation could be both disruptive and costly. Implementation of Modification Proposals such as this could undermine the confidence of market players. To date Transco has already procured, from a number of Users, a proportion of the SP requirement for the 2003/4 formula year. Some of this gas has been procured at the beach, under terms that Transco believes ensure that such purchases must be considered consistent with the economic, efficient and co-ordinated operation of the System. Implementation of this Modification Proposal would be inconsistent with the terms of some of those trades, necessitating renegotiation. Transco believes that implementation of this Modification Proposal would therefore undermine User confidence in transacting with Transco thereby undermining competition between Shippers in respect of the provision of services to Transco. Furthermore, the increased risks, to Users, posed by such contractual changes may lead to increased costs for future contract arrangements with Transco.

Transco agrees with BGT and Scottish Power that for the incentive to operate effectively, Transco should not be restricted to sourcing shrinkage gas from the NBP. Such a constraint is unlikely to facilitate choice and hence might be expected to lead to inefficient outcomes in encouraging incentive performance and managing risk.

Review of Shrinkage Provider Account Operation

Four of the respondents (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. 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.

Transco's Response

Transco considers that the current Licence, in the context of both the Network Code and the operational and contractual arrangements associated with the SP account facilitates delivery of 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 revised Modification Report contains Transco's proposal not to modify the Network Code but has been prepared following direction from the Gas & Electricity Markets Authority.

19. Text

SECTION N: SHRINKAGE

Amend paragraph 4.2.2(a) to read as follows:

"4.2.2 The Shrinkage Provider:

(a) may purchase gas in respect of shrinkage:

(i) provided such terms include a requirement that the Shrinkage Provider and the counterparty shall give effect to the sale and purchase of shrinkage gas by making Trade Nominations in accordance with Section C6; and

(ii) save for the requirement in (i) above, on such other terms as it thinks fit;"

Amend paragraph 4.2.2(e) to read as follows:

*"*4.2.2.(e) shall not be required to apply for and pay for NTS Exit Capacity, LDZ Capacity or Commodity Charges; and require (in respect of LDZ Shrinkage)gas flows at NTS/LDZ Offtakes without incurring Overrun Charges under Section B.*"*

Signed for and on behalf of Transco.

Signature:

Nigel Sisman
Development Manager Gas Balancing
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 **0599**, version **2.0** dated **29/08/2003**) 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 **2.0**.

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 <u>(whether such approval is actual or deemed by effluxion of time)</u> 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, <u>had it not been repealed, would</u> 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) <u>or 2(2)(b)(ii)</u> 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.