

URGENT Modification Report
Prospective publication of further forward and option entry capacity information
Modification Reference Number 0587

Version 1.0

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 Transco has recently begun tendering for entry capacity buy back forward and option contracts. An urgent decision about the level of information that should be published (if any) regarding the results of these tenders is therefore appropriate. In addition this information may be relevant to Users ahead of the forthcoming LTSEC auctions which are currently scheduled for January 2003.

Procedures Followed:

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

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| Issued to Ofgem for decision on urgency | 20 September 2002 |
| Proposal agreed as urgent | 23 September 2002 |
| Proposal issued for consultation | 24 September 2002 |
| Close out for representations | 1 October 2002 |
| Final report to Ofgem | 4 October 2002 |
| Ofgem decision expected | 9 October 2002 |

1. The Modification Proposal

The Proposal requires that Transco should be obliged to publish further information about the outcome of forwards and options tenders that might be conducted in the future in respect of secondary capacity rights. Currently, the Network Code only places an obligation on Transco to publish certain data in respect of forwards and options contracts where the number of Option or Forwards counter-parties (considered separately) for each ASEP and period combination exceeds 3. This Proposal removes that threshold for publication and extends the scope of the data to be published.

2. Transco's Opinion

Transco does not support implementation of this Proposal. When Transco is conducting tenders for capacity forwards and options contracts it is purchasing capacity in a secondary market. Transco is thus transacting in a similar manner to any other User (whether physical player or trader) for whom there is no obligation to publish any information about their trading activity or position. The incentive structures deliver alignment between Transco and the community

interest which Transco believes is best served by allowing discretion in respect of the information it releases in respect of its forward contracting activity.

The following provides a more extensive articulation of the Transco position:

Transco is incentivised to manage the risk/reward associated with the capacity regime. The Transco Licence and the Network Code have been structured to produce an alignment between the commercial objectives of Transco and the interests of the Community. This alignment has been designed to produce an efficient competitive outcome that might be expected to foster competition for the benefit of end users. Implicit in this was an understanding that Transco would be able to exercise increased levels of commercial discretion. Wherever possible, and appropriate, Transco should seek to operate efficiently in the market place in a similar manner to any other player. This is of particular significance in the context of information release.

Transco notes that in some activities, for example in the release of primary capacity, it is in a monopoly service provider position and hence it may be appropriate for it to have defined obligations in respect of the publication of information about the extent of capacity sold and primary capacity value.

However, when Transco is conducting tenders for capacity forwards and options contracts it is purchasing capacity in a secondary market. Transco is thus transacting in a similar manner to any other User (whether physical player or trader) for whom there is no obligation to publish any information about their trading activity or position.

The current regime requires Transco to offer for sale system entry capacity that is generally acknowledged to be in excess of the physical capability of the network. The regime structure has therefore, by design, placed Transco in a distressed position. Transco considers that it has efficiently managed the buy-back risks that it faced this summer and that a key element of this success was the policy adopted in respect of information disclosure.

Ofgem are in possession of comprehensive data about the outcome of the tender processes conducted to date. Transco was able to mitigate considerable exposure by the forwards and options contracting process this summer.

As an example, Transco procured extensive cover through August forwards at a discount of approximately 60% below the prices for comparable cover available in the first tender. Transco does not believe such a favourable result would have been secured with high levels of information disclosure.

Transco considers that it is unlikely, given the number of players seen in the tender processes or those that might realistically have been assumed to be possible participants, that further information disclosure would have promoted a more economic and efficient outcome.

However, despite the experience to date, Transco does not believe that limited information release would always give rise to the most efficient outcome. Transco would want to continue to exercise discretion in respect of the extent of information release. The regime has only

operated for 6 months and liquidity is a long way from where full automatic information release would, in Transco's view, be likely to increase efficiency. Where Transco believes greater levels of information release would promote improved liquidity to yield improvements, in the efficiency of procurement activities, then it would want to release such information.

In a competitive market, a User would not be able to influence the market price for buy-backs and would simply bid to reflect opportunity cost. Transco believes this is supported with the pricing guidance provided in Ofgem's letter 'NTS Capacity constraints and conduct in the buy-back market' (18 October 2000). Transco therefore considers that it would be neither economic nor efficient to be obliged to publish data that could act as a guide for price setting by counter parties. Transco believes that those Users selling capacity back to Transco would use previous prices as a guide, which might constitute a floor. In the illiquid capacity market this might encourage price escalation, rather than the downward pressures that have been experienced this summer when Transco has only furnished the Community with limited data.

Transco has extensive experience of monitoring the RGTA within day capacity prices. Transco's interpretation of the prices is that generally prices are not normally set by individual Users' value of capacity, but rather by reference to prices declared by other participants. In particular, Transco also notes that there are frequently major dislocations between prices available in the OTC market between Users and on RGTA where one counter-party is Transco. Transco does not believe that such dislocations would occur in a competitive market. Transco is anxious that publication of increased data in respect of forwards and options might see changes in behaviours in such tender processes that exploit Transco's distress thereby generating increased costs to the community.

Transco remains concerned that publication of the requested data could expose confidential information about its position and other individual parties, particularly if only one or two Users were to offer capacity in a tender. In these circumstances the data would also inform those Users that they might be in a position of a dominant seller which might have an undue influence on subsequent pricing of offers. Transco therefore maintains that if reporting obligations are to be introduced that such data should only be released in the context of there being in excess of 3 successful tenderers in respect of each tender/ASEP/time period combination.

Given its position as a distressed buyer, further information release under circumstances where there is limited competition to sell back to Transco will only serve to exacerbate the extent of Transco's distress, increasing exposures for Transco and the community.

It is conceivable that market participants might adopt extreme capacity positions in anticipation that Transco will need to buy-back to effectively manage exposures. Further information release might better inform such participants of the value that they might be able to extract from the regime. This might increase short-term costs for the industry but with no assurance that longer-term benefits in respect of increased competition might accrue in the longer term.

Transco notes that that it has been suggested that, if implemented, the Proposal would allow Users to assess historic overrun charges and to check capacity invoices. Transco does,

however, already ensure that sufficient information is available for Users to assess the expected overrun charge level taking account of all relevant prices associated with capacity transactions. Additionally full supporting evidence is supplied in respect of any overrun charges on the capacity invoice.

Transco considers this Proposal seeks to impose unnecessary and inappropriate obligations on Transco that do not apply to any other participant in this secondary market. Transco is not aware of any other secondary markets where disclosure of an individual participant's trades is required. In particular Transco would like to draw attention to the situation in the storage market, where the dominant Storage Operator is only required to publish information following a primary auction and no data is published concerning any bilateral trades, even in respect of primary capacity release.

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

The Proposer suggested that "This modification, if implemented, would better facilitate the relevant objectives of the efficient and economic operation of the pipeline system by facilitating new entry and greater competition in selling forward and option contracts to Transco. It would also better facilitate competition between shippers and suppliers by reducing risk."

Transco does not believe that the Proposal would further the relevant objectives.

4. The implications for Transco of implementing the Modification Proposal , including
a) implications for the operation of the System:

Transco is concerned that the Proposal might have a detrimental impact on the operation of the System.

Transco believes that greater information disclosure may discourage participation in forwards contracting leaving Transco with greater dependence on the RGTA capacity buy-back mechanism. This mechanism has been observed to be highly illiquid. Should the liquidity not improve it is therefore possible that reduced participation in forwards contracting could increase the risks of a greater incidence of Terminal Flow Advices (TFAs).

b) development and capital cost and operating cost implications:

Implementation would involve additional administrative effort each time Transco conducts forward or option tender processes. It is possible that the provision of the information might increase prospective buy-back costs.

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:

Any additional System Operator costs incurred as a result of implementing this Proposal would be shared with Users under the proposed incentive schemes, as defined in the Transco Licence.

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

Transco is not aware of any consequences this Proposal would have on price regulation.

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

This Proposal would increase the level of contractual risk to Transco as it would change the basis on which it had entered into forward and option contracts with Users. It may also limit the extent to which Users are willing to contract with Transco for capacity buy-back. As illustrated elsewhere, Transco believes that participation in subsequent tenders might be more limited and that this might increase the risk of TFAs.

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

If implemented, Transco would envisage publication of the required data in a standardized data format via the Transco Website. Users would then need to download the data and further process (if required) within their systems.

7. The implications of implementing the Modification Proposal for Users

If implemented then this Proposal would result in Users having access to information about the outcome of tenders for forward and option contracts for entry capacity buy backs. However it could also result in commercially confidential information about Users being published in the circumstances where limited numbers of Users responded to the tender or had offers accepted. By increasing the extent of Transco's distress, it is possible that this Proposal might increase costs paid in aggregate by Users.

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

Transco has not identified any implications for Terminal Operators, Consumers, Connected System Operators, Suppliers, Producers and any Non-Network Code Party.

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

This Modification Proposal would change the basis of the forwards and options contracts.

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

Advantages:

- Users would have access to additional information;
- Increased information may promote liquidity;
- Users can better understand extent of Transco's distress; and
- Clearer indications of the value Transco ascribes to capacity.

Disadvantages:

- Commercially confidential information could be published;
- Prices for forward and option contracts might increase and might not reflect a Users' valuation of capacity;
- Users may face higher costs through their share of buyback costs;
- Risk of reduced forward liquidity; and
- May discourage Users from offering capacity at their opportunity cost.

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

Transco notes that only seven representations were received:

- British Gas Trading Ltd. (BGT)
- Shell Gas Direct (Shell)
- Energy-Koch Trading Limited (EKTL)
- Marathon Oil UK Limited (MO)
- SSE Energy Supply Ltd (SSE)
- AEP Energy Services (AEP)
- LE Group (LE)

All seven representations supported implementation of the Proposal.

11.1 Increased Competition and Market Liquidity

Respondents indicated that the Proposal might further promote competition and improve liquidity. For example, LE stated that the Proposal would “*enhance the transparency of the forwards and option tender process and, through the provision of information, create further competition in the secondary markets*”.

Transco Response

Transco acknowledges that where there is a high degree of competition information release might be expected to promote improved liquidity and hence more efficient outcomes. However, Transco notes that this might not always be the case. Transco also notes the AEP comment that “*AEP does not agree that publishing this information will lead to higher prices*”.

over a sustained period or to any material degree". Transco acknowledges that there is a risk that publishing this information may lead to higher prices and this is why Transco considers that a more efficient outcome would arise from it having discretion in respect to what information it releases in a similar way to that exercised by other market players.

Transco continues to be concerned about the issue of Users exercising "pricing power" which would be mitigated by deep and liquid markets. However, Transco contends these do not exist, even in the prompt buy back market where there is full transparency. It is possible that a lack of liquidity would provide a further signal to the limited number of potential counter parties to increase prices.

Transco contends that it has efficiently managed exposures to date and that it should, given its awareness of the limited number of market participants, exercise discretion in the best interest of Transco and the Community.

11.2 Monitoring of Transco

Shell comment "*it is essential that market players are able to monitor Transco's activities effectively*". BGT note "*the community requires this information to manage our risks and to be able to track whether Transco have spent community money prudently and efficiently*".

Transco Response

The proposed changes to Transco's GT Licence include incentive arrangements that are intended to align Transco behaviour with desirable outcomes. When operating in accordance with incentives, Transco believes that it should have freedom to develop novel and innovative approaches to promote efficient system operation. Transco believe that the philosophy underpinning the development of the current regime was that Transco should have increased commercial discretion. This would be consistent with a reduction in prescriptive requirements being placed upon Transco, which should include information provision. Transco has provided, and expects to continue to provide, details of all tenders to Ofgem. Transco will, however, continue to provide information to Users in a timely manner to enable Users to assess their risk exposures.

The SO incentive schemes are designed to promote low cost system management with any benefits of improved performance being shared between Users and Transco. This should provide an alignment between the interests of the Community and Transco that generates an appropriate driver for Transco to manage such costs. However given the nature of the redistribution and the benefits accruing to individual Users from the acceptance of forwards and option contracts there will not always be alignment between an individual User and the interests of the Community. Therefore Transco does not consider it appropriate or desirable from a community perspective for market players to be able to monitor Transco's activities.

Whilst it might be appropriate to consider independent audit of Transco's actions, given that Users will be sellers to Transco, it seems imprudent for Users to see all information directly relating to Transco's position given the nature of its distress. Such data release would only

seem equitable if all other parties had similar obligations to publish their positions and details of their trading activity.

11.3 Commercial Confidentiality

AEP “does not believe that information relating to capacity management agreements is, or should be, commercially confidential. Transco already publishes detailed information on bids and prices following primary auctions Information on capacity management agreements should be published in the same way”. Shell noted “Transco’s concerns about commercial confidentiality” but concluded that Shell did “not consider that this concern is over-riding”.

SSE indicated that “it is important for the overall success of the tender process that commercial confidentiality is maintained”.

Transco Response

Transco currently provides extensive information about the primary sale of capacity and that such data is appropriate given Transco’s monopoly role in respect of primary capacity provision. Transco does not believe that this is applicable to secondary market activity where Transco would wish to compete on a level playing field with all other participants. Transco notes that the Proposal would effectively change the basis under which counter-parties contracted with Transco. This implementation might represent a breach of confidentiality and act as a deterrent to Users taking part in future buy back tenders given the increased risks that counter-parties might expect.

Transco notes the SSE and Shell comments that it would be preferable to maintain the principle of commercial confidentiality.

11.4 Alignment with Electricity Information Provision

LE noted that “the modification would further align the gas market data release with that seen in the electricity market”.

Transco Response

Transco considers that it is essential to consider the fundamental differences in the tools that are available to gas and electricity System Operators. In electricity the tools are “physical” and designed to deliver physical changes as a direct result of exercise. Such tools are typically only required by the electricity SO which is therefore effectively in a monopoly procurement role, with no other market participant likely to want such services. Entry capacity, by contrast, is a “paper” entitlement with no direct link, or expectation of physical changes resulting from deployment. Physical flow changes will only arise in the context of the commercial incentives inherent in the regime that arise as a consequence of the trade. Transco is just like any other player in the secondary market, buying and selling an option rather than an obligation, other than the fact that it is prohibited from transacting in the primary allocation (other than where it

might choose to sell capacity above baseline quantities). Transco should therefore not be subject to obligations that do not apply to other players.

11.5 Transco Special Position

AEP note “*Transco is the monopoly owner and operator of the NTS and is not analogous to shippers buying and selling capacity in the secondary markets*”. AEP also indicate that, unless Transco is obliged to publish more information about forwards contracts *it is able to “exercise market power and artificially lower prices and/or discriminate in the terms it offers to different shippers for the provision of the same services”*”.

Transco Response

Transco, as the monopoly seller of primary capacity, is not permitted to purchase capacity in the primary auctions. It is therefore not analogous to Users who have the option of procurement in the primary auctions.

Transco notes the suggestion that Users might choose to sell capacity back to Transco at lower prices. This implies that Users are currently able to extract prices from the regime above their valuation. Transco believes that this identified problem would be further exacerbated by increased obligations on Transco to publish the outcomes of forwards and option tenders.

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 Modification Proposal

Additional work would be required to facilitate the implementation of increased information.

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

As Transco does not support implementation, no timetable is provided.

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

Transco does not recommend implementation of this modification.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: 4 October 2002