Modification Report
Availability of Surrendered Entry Capacity
Modification Reference Number 0581
Version 1.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

The Proposal states that under Network Code Modification 0559: "Changes to Buy-Back Liabilities", the capacity neutrality driver was changed from registered monthly entry capacity to end of day firm capacity holdings with costs and revenues smeared nationally. Therefore, Users holding any form of firm System Entry Capacity at the end of the gas day will incur a share of any buy-back liability from Transco's actions in re-acquiring Entry Capacity. As part of this development Transco has offered, with reasonable endeavours, to accept zero-priced offers to buy-back unused capacity up to 1700 hours within day. This reduces the Users potential buy-back liability.

Following implementation of Modification 0559, a Proposal has been made such that the capacity bought back by Transco should be offered by Transco for use by any User at zero cost.

Following Workstream discussion the Proposer submitted the following business rules:

<u>Principle objective of Modification</u>
Following the implementation of Modification 559 "Changes to Buy-Back Liabilities", Users holding any form of firm System Entry capacity at the end of the gas day will incur a share of any buy-back liability from Transco's actions in re-acquiring Entry Capacity. As a part of this development, Transco have offered, with reasonable endeavours, to relieve Users of any unused Entry Capacity at 17.00hrs at zero cost, in order that this liability may be reduced.

There may be circumstances, following Transco's assessment of available capacity, where this capacity could be made available later in the same gas day. In which case Transco should be obliged to offer this capacity for use by any User. This will ensure that the maximum amount of firm capacity will continue to be available to the community and not unnecessarily restrict flow of gas on to the system.

<u>Process</u>

1. Following any firm capacity surrender [or buy back] [at or up to 17.00] on the gas day, Transco will continue to assess the level of firm capacity which could be made available at each ASEP. At any time if the ASEP Capability is such that an amount of available firm capacity at any ASEP is greater that that quantity

sold, Transco will indicate the availability prior to the next hour bar up to 02.00 in a Capacity Allocation Period as defined at per B2.4.13(h)). This availability will be on the basis of the capacity rate and the remaining hours of the gas day in which flows can be accomplished.

2. This will be indicated in the Standard RGTA Capacity system (Auction Capacity Available screen). Any User will be eligible to accept this capacity subject to Code rules but at zero cost.

3. In the event that here are competing acceptances of this capacity at any hour bar the capacity will be allocated to each accepting User pro rated in proportion to their acceptance. (Following the procedure described at B2.7.2 (d specifically)).

   2.7.2 For a relevant short term period, System Entry Capacity in respect of an Aggregate System Entry Point will be allocated pursuant to capacity bids submitted in respect of such short term period as follows:

   (d) subject to paragraph (e) and paragraph 2.7.3, where each of two or more bids ("**equal priced bids**") specifies the same bid price, and the amount of relevant capacity remaining applied for in aggregate under such bids exceeds the remaining unallocated amount, the remaining unallocated amount will be allocated pro rata the amounts applied for in each such bid;

4. Any capacity allocated to a User in this process will be included in the aggregate capacity holding. This figure will be included within invoices (at zero cost) and will be the figure upon which Buy Back Liabilities will be allocated.

2. Transco's Opinion

Transco does not support implementation of this Modification Proposal.

Transco's GT Licence sets out the circumstances by which Transco is deemed to have discharged its obligation to offer baseline capacity as well as the treatment of revenues that may arise. In Transco's opinion, this Proposal is not consistent with the recently established GT Licence arrangements. In particular, the GT Licence directs revenue from all within day sales to the Entry Capacity Buy-Back Incentive. The premise of this Proposal is that the revenues that may arise from re-selling previously bought back entry capacity should be counted towards allowed revenue and therefore should be fixed at a zero price so that Transco does not receive allowed revenue twice. Modification of Transco's GT Licence would be required for this to be implemented.

The modification proposes that capacity is released at zero price. However, if competing bids are received at the same price for a greater level of capacity than is available, the allocation would be scaled back pro-rata to the bid. Transco is concerned that a fixed zero price allocation may present Users with an incentive to overstate their demand, which could result in an inefficient allocation and the provision of misleading demand signals.

Transco believes that it would be inappropriate to introduce a fixed price allocation for certain quantities of firm entry capacity whilst maintaining provisions for allocation by auction for other quantities of firm capacity which if the proposal is implemented, should operate in parallel to each other. Transco believes it is inappropriate to introduce changes to pricing arrangements through the Network Code rather than the Transportation Charging Methodology, with reserve prices set in accordance with the requirements in Condition 4 of Transco's Licence.

Transco does not believe implementation of the proposal would have any implications with respect to interactions between the gas and electricity regimes.

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

In Transco's opinion, the proposed Modification would not better facilitate the relevant objectives. In particular, that the proposed allocation at a fixed zero price could provide Users with an incentive to inflate demand, and consequently would be less efficient than the established capacity release process. Daily allocation processes could become more complex and consequently less efficient if dissimilar allocation processes are expected to be operated on the same day for capacity to be used effectively at the same time.

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

a) implications for the operation of the System:

There is unlikely to be a change in physical operation of the System as a result of implementation of this Proposal.

b) development and capital cost and operating cost implications:

A new release process would be required to enable capacity to be offered at a fixed price and to provide a mechanism to pro-rate demand as appropriate. The release process would be expected to potentially run alongside the existing release processes and could be operated more than once on any day.

No development or capital costs have been identified at this stage. Operating costs are expected to be minimal if the proposed capacity release process can be conducted by the present complement of operational staff.

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 accounted for under the cost incentive scheme as part of Transco's Licence arrangements.

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

The Proposal identifies a treatment of revenue arising from sales of some Daily System Entry Capacity that is not consistent with the present licence arrangements. In particular, revenue accruing to the Entry Capacity Buy-Back Incentive would be changed.

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

There are no such consequences.

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

Transco would need systems development to create the proposed release process. It is anticipated that a screen based process would be established to enable Users to input bids. A provisional estimate of the time required to deliver the necessary systems is nine months.

7. The implications of implementing the Modification Proposal for Users

The implication of implementing the Modification Proposal is that Users could be unclear as to the level of zero-priced capacity they should bid for.

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

There are no such implications.

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 believes that the Modification Proposal is not consistent with its Licence arrangements. In particular, this Proposal is not consistent with the Licence definitions of which capacity constitutes baseline capacity and revenue treatment for Daily System Entry Capacity sold within day.

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

Advantages:

- Users may take the view that they will be able to access zero-priced capacity.

Disadvantages:
- Inconsistency with Licence arrangements.
- Users could receive confusing signals on capacity availability.
- Potential inefficiency arising from incentives on Users to overstate demand.

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
Representations have been received from:

AEP Energy Services (AEP)
British Gas Trading (BGT)
Entergy-Koch Trading (EKTL)
Innogy (INN)
London Electricity (LEG)
Powergen (POW)
Shell Gas Direct (SGD)
Statoil UK (STUK)
TXU Europe (TXU)

One respondent, the Proposer (BGT), supported implementation of the proposal (with an amendment), three respondents offered qualified support (LEG, POW, SGD) and five respondents (AEP, EKTL, INN, STUK, TXU) did not support implementation of the proposal.

Of those that supported or offered qualified support for the proposal, LEG and POW noted that it was not clear how the proposal would work in practice. The Proposer, in its representation, suggested amending the proposal.

11.1 Capacity Offered for Re-release
Three respondents (BGT, POW, SGD) supported the principle that once capacity has been surrendered to Transco, Transco should make this available to Users whenever possible.

TXU supported that the maximum amount of firm capacity should be made available to the community for use.

LEG stated that all System Entry Capacity should be made available to the shipping community as and when possible but were unsure as to how Transco will assess what capacity should be made available i.e. should this be all capacity bought back by Transco or will it be based purely on surrendered capacity.

Three respondents (AEP, EKTL, STUK) did not support that capacity surrendered to Transco should be offered for resale by Transco.

AEP noted that “experience to date suggests that most shippers choose not to surrender capacity back to Transco. This would suggest that the risk identified by the Proposer that capacity would be withheld from the market later in the day is not a significant one”.

EKTL did not consider that Transco should be under any obligation to offer this surrendered capacity back to the market in a manner other than as dictated in the current rules for capacity release.

STUK “feel that there are already other suitable mechanisms for obtaining entry capacity within day and if shippers choose to sell their capacity at zero price then Transco should not have to offer this capacity again”.

Transco Response

Transco notes Users wish that the maximum amount of capacity should be made available at any given time and that some Users believe that capacity surrendered to Transco should be re-offered for sale. Transco believes that the recently established GT Licence incentive arrangements provide an appropriate framework and incentives for management of entry capacity. In particular daily capacity release should be conducted with regard to the risks and rewards that are provided by the buy-back incentive in addition to wider considerations of the GT Licence and Gas Act. Transco does not agree that further provisions for capacity release are required.

11.2 Zero-Priced Capacity

Three respondents (BGT, SGD, INN), including the Proposer, suggested that the proposal would work better if the capacity were offered for resale at a zero reserve price rather than a fixed zero price and any excess demand for capacity re-released could then be allocated by price.

POW had concerns how (the proposal) would work in practice, specifically regarding Transco having to release capacity at zero cost. POW were also unclear as to how the redistribution (of re-released capacity) would be monitored as it would be difficult to distinguish from within-day firm capacity.

LEG “are not sure of what would be the best price for the extra capacity but do not think that it should be at zero cost”.

AEP noted that “the proposal to re-release capacity at a fixed price of zero is (in its current form) unworkable and would lead to inefficient release of capacity at below its market value on certain days and that the release of capacity should be at a price determined by Transco depending on shipper demand and Transco’s assessment of the risks and costs of buybacks”.

TXU did not support the suggestion of selling this capacity for non-zero cost as it would result in two portions of revenue for the same unit of capacity.

STUK noted that a zero price and prorating methodology is not in-keeping with other short-term forms of capacity release. Also that there would be issues with Transco reselling this capacity for prices above zero as they would already have earned transportation revenue on this capacity.

Transco Response

Transco agrees with the majority of respondents who are of the opinion that an additional fixed zero price allocation for firm capacity is impractical. Whilst not forming part of the modification proposal Transco recognizes that a number of respondents are of the view that a zero reserve price might be appropriate for within day firm capacity auctions which would be more consistent with the recently established pricing methodology proposed in pricing consultation PC76,"NTS TO Entry Capacity Auction Reserve Prices and Exit Charges", whereby, from October 2003, all DSEC sold on the day of the capacity itself would have a zero reserve price.

11.3 Capacity Allocation Mechanism

POW stated that "scaling is not a very efficient way of allocating capacity" and that "the only practical solution is to release this capacity as within day firm with a reserve price, which is not a better solution".

AEP noted that pro-rating of bids would not lead to an efficient allocation of entry capacity.

EKTL stated that "the complexities arising from a having a separate class of capacity and pro-rating make this proposal very unattractive."

STUK stated that prorating mechanisms could lead to overstating demand.

Transco Response

Transco agrees with respondents that scaling back bids pro-rata if large quantities of competing bids are received at the same price for a greater level of capacity than is available is unlikely to lead to an efficient allocation.

11.4 Treatment of Revenues

BGT suggested that any revenue secured from re-released capacity "should flow to Transco's [via] incentives, as is the case with other within day sales".

SGD "recognize that there may be an impact on Transco's target incentive revenues but do not consider that there will be a significant effect and this can be reviewed in light of experience as part of Ofgem's review of the incentives for April 2004".

TXU noted that "whilst Transco may not accrue extra revenue as a result of zero cost sales, the volume sold would be distortionary".

INN stated that "the introduction of different within-day capacity products with different allocation and revenue treatment arrangements is overly complicated".

Transco Response

Transco recognises that under the proposal that capacity is allocated at a fixed, zero price, there would be no additional revenues to Transco. However, Transco notes that arrangements would need to be established to ensure that capacity formerly surrendered at a zero price is not confused with capacity that might have been bought back at a non zero price or is to be offered for the first time (a primary allocation).

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

A Pricing methodology change would be required to enable the Daily System Entry Capacity identified in this Proposal to be released at a fixed price.

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

Design and build systems (9 months).
Conduct User training (1 week).
Write legal text (2 weeks in parallel) .

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

Draft Modification Report issued	7 November 2002
Close out for Representations	28 November 2002
Issue Final Modification Report	19 December 2002
Ofgem decision expected	End December 2002

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of the Modification 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:

Tim Davis
Head of Regulation NT&T

Date: