

**CSEP ANCILLARY AGREEMENT WORK GROUPS FOR BACTON AND
MOFFAT**

OPTIONS FOR CAPACITY TREATMENT

DRAFT PAPER

PURPOSE OF PAPER

This paper provides a summary of the discussions that have been held in the two Interconnector work groups. The ideas expressed are not meant to represent the views of Transco or provide any indication of options acceptable to Transco, but provide a summary of the discussions.

The paper is directed initially at the Modification Review Group for 0117, but the group is requested to approve the presentation of this paper to the Pricing Steering Committee.

STRUCTURE OF REVIEW GROUP

The Modification 0117 Review Group set up two work groups to develop the CSEP Ancillary Agreements for the UK-Continent Interconnector and the UK-Ireland Interconnector. This paper is the first report to the Review Group. It has been possible to incorporate the debate and initial conclusions of both groups in to one paper. Where there is some differentiation between the two Interconnectors these are highlighted.

The work groups consist of a broad mix of interests including downstream capacity holders (current and future), NTS shippers - current and prospective shippers to that point, Transco.

OVERSELLING OF CAPACITY

One of the principles encapsulated in Modification 0117 was the restriction that Transco would not oversell capacity at the Interconnectors. It was concluded that this approach had been correct as it was neither in the interests of Transco to oversell firm capacity at an offtake (this might result in placing Transco in breach of Code obligations) or in the Shippers interest as any overselling would undermine the effectiveness of firm capacity rights. No arguments in support of the principle of overselling were proposed.

USE IT OR LOSE IT

As part of the discussions at the review Group there has been some detailed and careful consideration of the suggested introduction of a "use it or lose it" test to capacity. This would be an alternative to the current "book it or lose it" approach that has been adopted in Code for Supply Points. The Review Groups have considered the appropriateness of this type of test for the Interconnectors.

The group used the assumption that the "use it or lose it" approach would be a retrospective view of how much capacity was utilised during the year and whether there was sufficient usage to justify the continued rights to the capacity.

The key areas of discussion are outlined below:

- * By the very nature of firm capacity being reflective of the peak requirements there will inherently be an underutilisation of this capacity for much of the year. However, this capacity has been paid for and Shippers expect to be able to retain the rights since they have paid for the capacity.

- * If the "use it" test was applied to the commodity throughput, then there will be discrimination between different users who have different usage profiles. One user may only require winter usage, but need a significant amount of capacity to ensure that this peak load can be met, therefore, the ratio of capacity booked to volume flowed would be much higher than for base load usage.
- * For transportation to Continental Europe, Ireland and Northern Ireland the market structures and customer base requires long term assurances that capacity will be available. The end users are requiring, in their long term contracts with Shippers, the same level of assurance as to capacity at the interface with the UK system as they are provided with throughout the rest of the transportation route.
- * It may be that as a consequence of events outside of the control of the shipper, the volume of gas or usage of capacity to a particular offtake may have been limited during the previous year, however, the Shipper anticipates that a return to full utilisation would take place in the following year. Under a retrospective "use it or lose it" approach the Shipper may be prevented from meeting a genuine requirement.

The overriding theme that was clear from the discussions was that the market clearly differentiates between a need for capacity and the use of capacity.

Additional concerns about the practicality of this type of test were raised:

- * In the context of the above issues, what level of usage would be appropriate.
- * What would happen in the event that the capacity had been traded on the secondary market and then under utilised. Should the original holder of capacity be penalised in this instance.

The group recognised that there were genuine concerns in respect of the monopolisation of capacity and the efficient utilisation of capacity at the Interconnectors. Both groups unanimously concluded that the options being considered under the "book it or lose it" principle (in combination with a test of bona fide evidence) could deal simply and effectively with these concerns.

AUCTIONING OF CAPACITY

One further proposal was discussed which focused on the prospect of an annual auction of the firm capacity at the Interconnectors. The theory of this approach was that the party which paid the highest price for the capacity would secure the rights for the next 12 months to this capacity.

The objective was to overcome concerns about the viability of sufficiently robust bona fide evidence and dealing with the perceived concern over the long term monopolisation of capacity.

It was the conclusion of the group that this approach did not meet the requirements of downstream capacity holders, end users or shippers. There was a very real concern that a party with no interest (other than for the purposes of trading capacity onwards at a profit) could obtain capacity, this would enhance the risk of monopolisation of capacity and the likelihood of genuine requirements for capacity not being met. There were a series of other concerns regarding the impact of this proposal, including the effect upon the LRMC approach adopted by Transco and Ofgas.

BOOK IT OR LOSE IT

Introduction

The groups have identified a number of options which retain in principle the "book it or lose it" concept, but also deal with specific concerns about ensuring efficient use of the Transco system and promoting competition in the supply of gas.

Throughout this section we refer to "Downstream Capacity Holders or DCH". This generic term has been used to refer to shippers in the UK-Zeebrugge Interconnector, end users in Ireland who are negotiating transportation arrangements with BGE and holders of capacity in the line to Northern Ireland.

OPTION 1 TRANSCO SHIPPERS BOOK AND HOLD CAPACITY ENTITLEMENT

Attributes

*** Transco Shippers book capacity**

This would follow the same model as applies at all other offtakes in the UK. In this case the shipper identifies the peak capacity requirement, reserves in advance (if necessary) and books (providing bona fide evidence) at the appropriate time in accordance with Code rules held in CSEP Ancillary Agreement.

*** Transco Shipper re-books capacity**

Transco Shipper has the automatic right to re-book (subject to bona fide evidence requirement) the capacity on an annual basis.

*** Bona Fide Evidence Required**

The Transco Shipper will be required to provide bona fide evidence, both initially and at the time of rebooking, to demonstrate a genuine need for the booked level of capacity. There are several practical and objective tests that could be applied:

- i) Shipper warrants that they have a sales agreement with a downstream capacity holder for an amount equal to the capacity booking request.
- ii) Shipper provides evidence of a sales agreement with a downstream capacity holder.
- iii) Shipper provides evidence of a transportation contract within the downstream pipeline system. This would be applied where the shipper had transportation arrangements in both systems.
- iv) Operator provides a capacity statement of which parties have capacity entitlement in the downstream system.

In cases (ii) and (iii) it may be that an independent agent would be required to validate the bona fide evidence.

It would be necessary for the same option (or combination of options) to be applied consistently across all Shippers.

*** A record of capacity entitlement is maintained and updated following release of new capacity and/or trading of capacity between shippers.**

*** Shippers need to appoint an Agent to manage within day and after day nominations of gas flow and validates against capacity entitlement.**

Advantages

- * Maintains symmetry with current booking rules in Code for other loads connected to Transco's System.
- * Fits within the current legal, licence and regulatory structures.
- * Shippers are assured that they have sufficient capacity to meet their sales agreements downstream.
- * Prevents long term monopolistic holding of capacity since there is a need to demonstrate bona fide requirements annually.

Difficulties

- * Ability for Downstream Capacity Holder to shift between Transco Shippers is either restricted or results in excessive booking of capacity by Shippers to meet their absolute obligations. The potential consequence of the overbooking is that shippers with a genuine requirement are locked out and/or there is excessive Transco investment in transportation capability to that point.

Due to the nature of gas sales agreements and their inherent flexibility it may be difficult for a liquid secondary capacity market to develop since shippers would have a genuine claim that their sales agreement resulted in a genuine capacity requirement. It is anticipated that at Moffat there may be sales agreements with flexible take arrangements which would result in the contractual maximum's exceeding the physical requirement, hence making validation of capacity against these inappropriate.

The use of transportation entitlement may provide a more appropriate measure for validating capacity rights.

- * Bona fide test may be difficult to confirm if the discussions on sales and transportation rights in the downstream system are dependent upon evidence of capacity entitlement in the Transco System. It might be necessary to introduce the concept of conditions precedent/subsequent with a time limit.
- * These capacity rules, in isolation, do not provide an incentive on Shippers to make effective use of capacity. Other factors specifically the price of the capacity will be influential in making effective use of capacity.

Option 2 DOWNSTREAM CAPACITY HOLDERS BOOK AND HOLD CAPACITY ENTITLEMENT

Attributes

- * Downstream Capacity Holder reserves in advance (if necessary), books and holds capacity.

Instead of the Transco Shipper booking and holding the capacity, this obligation would rest with the Downstream Capacity Holder.

It is not practical in Ireland, Northern Ireland or for the UK-Zeebrugge Interconnector to track the contracts back to the end users through several transit agreements, which may in any event be a gas distribution operator.

In Ireland the structure of the third party access would mean that the Downstream Capacity Holder would be the end user [or their agent].

- * The DCH has the obligation to pay for the capacity and therefore would need to be recognised as a user within Network Code.
- * The capacity entitlement is transferred to Transco Shippers on a daily basis at the same time as the gas flow nominations process.

Through this route the Transco Shipper (effectively seller of gas) can be assured that capacity will always be available in the required amount, so long as the Downstream Capacity Holder has booked capacity with Transco.

- * The DCH can shift between Transco Shippers intra year on a daily basis.

The Downstream Capacity Holder may enter in to any number of gas purchase agreements with varying flexibility.

- * The DCH would be required to provide bona fide requirements for capacity.

The bona fide evidence could only be based on the capacity rights in the downstream system. The effect upon the different Interconnectors would be:

The DCH for Ireland have a capacity entitlement in the Bord Gais Eireann System equivalent to their usage requirements. It is not anticipated that capacity in excess of that required by end users will be booked.

The DCH in Northern Ireland

The DCH at the UK-Continent Interconnector have rights to capacity in the Interconnector. It would be possible to demonstrate bona fide entitlement in proportion to the capacity rights in the Interconnector. These rights may not be fully utilised in each year and therefore an additional check might be necessary.

- * An Agent would need to be appointed to validate the nominations made by Transco shippers and those of the DCH (including the daily transfer of capacity from DCH to Transco).
- * The DCH would be responsible for the capacity charge payments to Transco.

This would be consistent with the current concept of capacity traders as a Network Code User. Transco Shippers would not be required to pay capacity charges at the offtake since these had already been received directly from the DCH.

Advantages

- * The bona fide evidence would always be based upon the downstream capacity rights and/or end users requirements. This process identifies the exact requirements and is not complicated by gas sales agreements which may not reflect the physical capacity requirements.
- * There is no need to create a secondary market in capacity between Transco Shippers (and the necessary rules, functionality and complexity) since competition in gas supply has been maximised.
- * Simplifies the Agents role in establishing capacity rights, validating and matching nominations.
- * Both parties are free to develop flexible gas sales agreements in the confidence that capacity will be available.
- * Transco Shippers have the opportunity to take advantage of short term and short notice opportunities to supply gas without the requirement to commit to long term capacity in Transco's System or pay inflated prices for capacity in the secondary market. Thereby, allows the market to concentrate on the key commodity - gas.

Disadvantages

- * Requires the DCH to be a holder of Transco capacity. This might prove difficult in an expanded Irish market.
- * In the event that not all DCH's wish to book and commit to capacity in the NTS, then this might introduce the necessity for an agent to represent small users. This would start to drift from the pure concept of the DCH holding the capacity and may provide additional bona fide test requirements.
- * Legal, statutory and regulatory issues will need to be addressed.
- * Credit vetting requirements for non-Shippers need to be considered.

Option 3 DOWNSTREAM CAPACITY HOLDER DICTATES CAPACITY ALLOCATION AMONGST TRANSCO SHIPPERS

- * This option is based upon the bona fide requirements in Option 2, where the DCH is required to provide bona fide evidence of a requirement.
- * The DCH would be expected to reserve capacity (with appropriate commitments) if reinforcement was required.
- * Would be necessary to retain a register of which DCH had entitlement to nominate a Transco Shipper to hold capacity. This register would also identify the associated peak capacity requirement.
- * The Transco Shippers hold the capacity and retain the obligation to pay for the capacity, however, the capacity is automatically transferred between Shippers based upon the requirements of the DCH.
- * The DCH advises Transco which Transco Shipper is being used and therefore which Shipper the capacity should automatically be transferred to.
- * Agent is required to be appointed to validate nominations and might have a role in the capacity confirmation/automatic transfer process.

Advantages

- * May overcome any contractual and legal difficulties with non-Transco shippers holding capacity.
- * Able to handle an increased number of end users in the event of reduction of the threshold in Ireland.
- * Transco retains the relationship with Transco Shippers for payment of transportation charges.

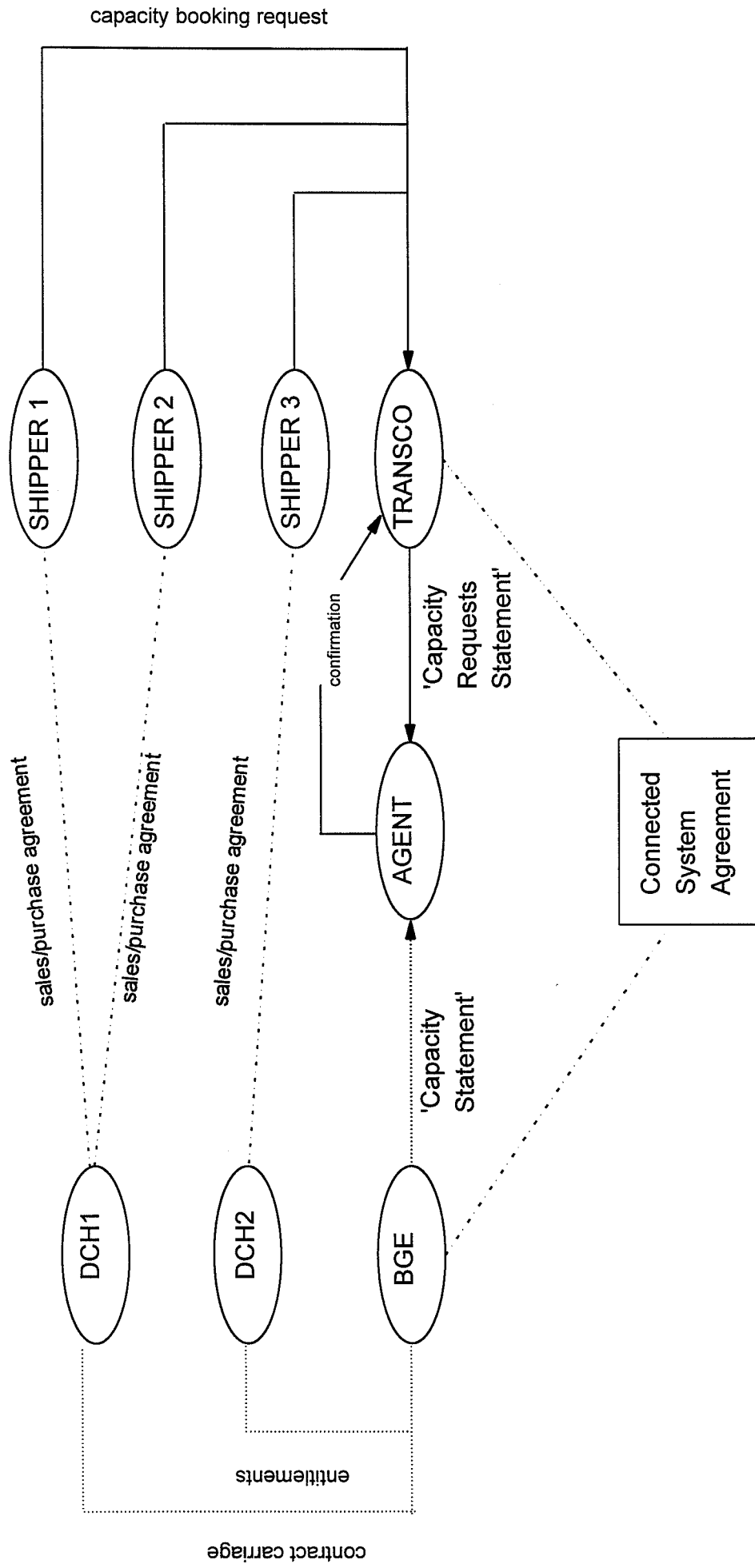
Disadvantages

- * DCH will still have ultimate responsibility for capacity charges.

INTERRUPTIBLE SERVICES

It has been recognised that there is scope for an interruptible service, however, the work groups believe it is necessary to formulate the firm service at this stage. This will provide the basis from which an interruptible service could be provided.

OPTION 1 - CAPACITY BOOKING (Transco shippers book and hold Transco capacity)

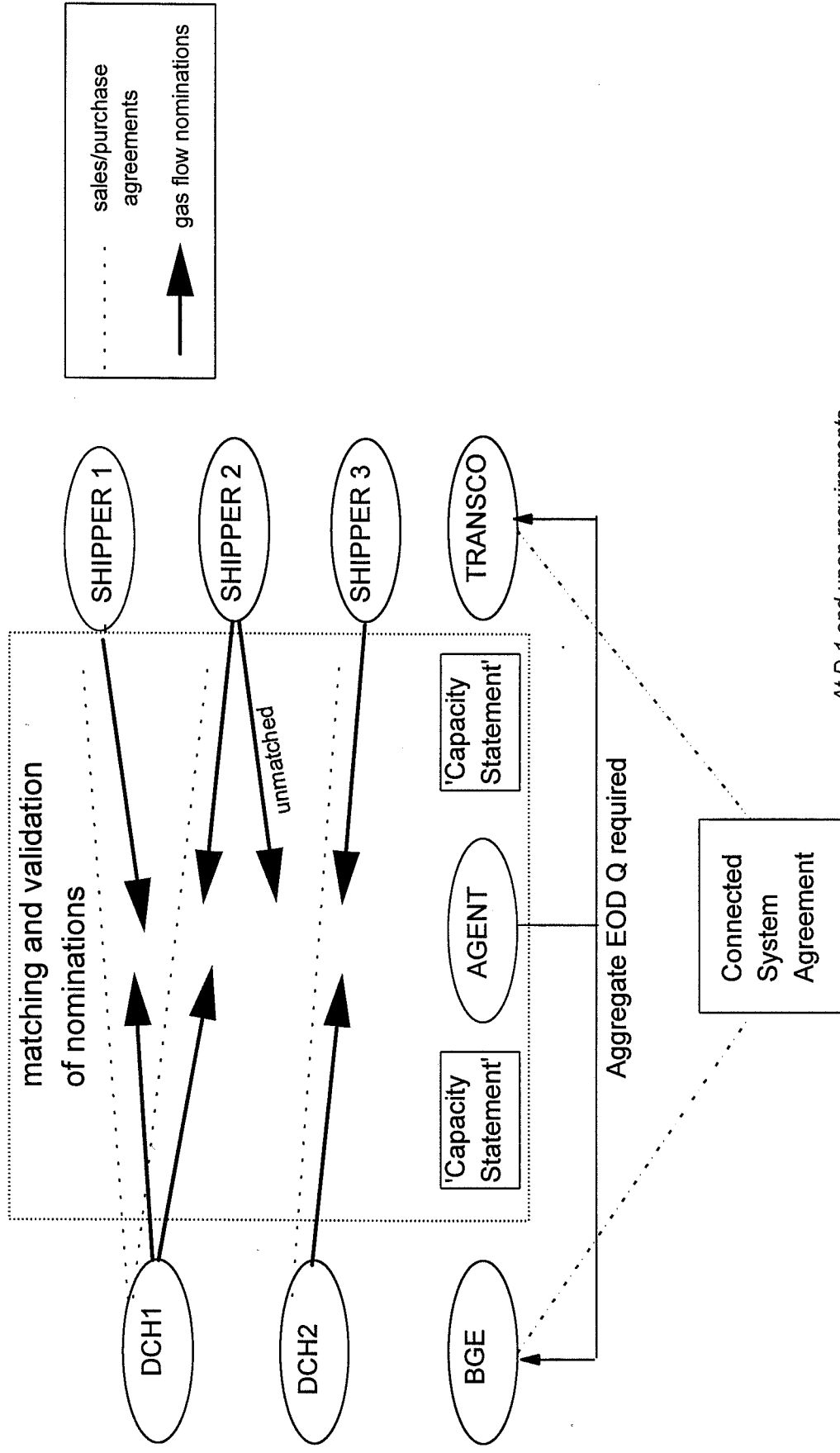


Prior to gas flow day and upon any changes

- Agent checks 'capacity request' statement against standing information i.e.
 - i) in aggregate against NExA
 - ii) sales/purchase agreement (quantities)
 - iii) D.C.H. 'capacity rights' on B.G.E. line, as defined in B.G.E.'s 'capacity statement'
- Agent confirms 'bona fide' rights to Transco
- Transco confirm requests to NTS Shippers, who then have booked capacity (precise mechanism of booking on UK LINK to be determined)

OPTION 1 - GAS FLOW NOMINATIONS

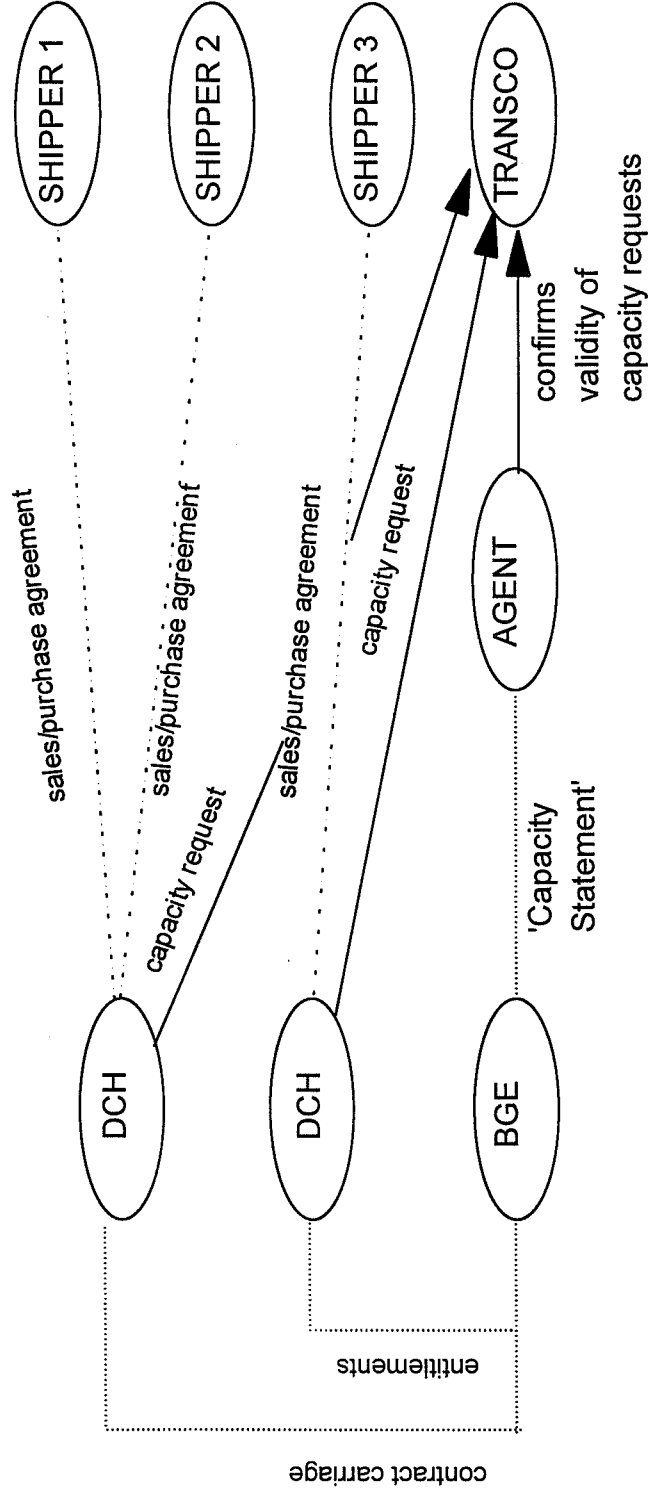
(Transco shippers book and hold Transco capacity)



At D-1 and upon requirements

- Agent validates D.C.H's nominations against carriage entitlements
- Agent validates Transco shippers nominations against Transco capacity booking
- Agent ensures upstream and downstream nominations match and notifies transporters of aggregate requirement

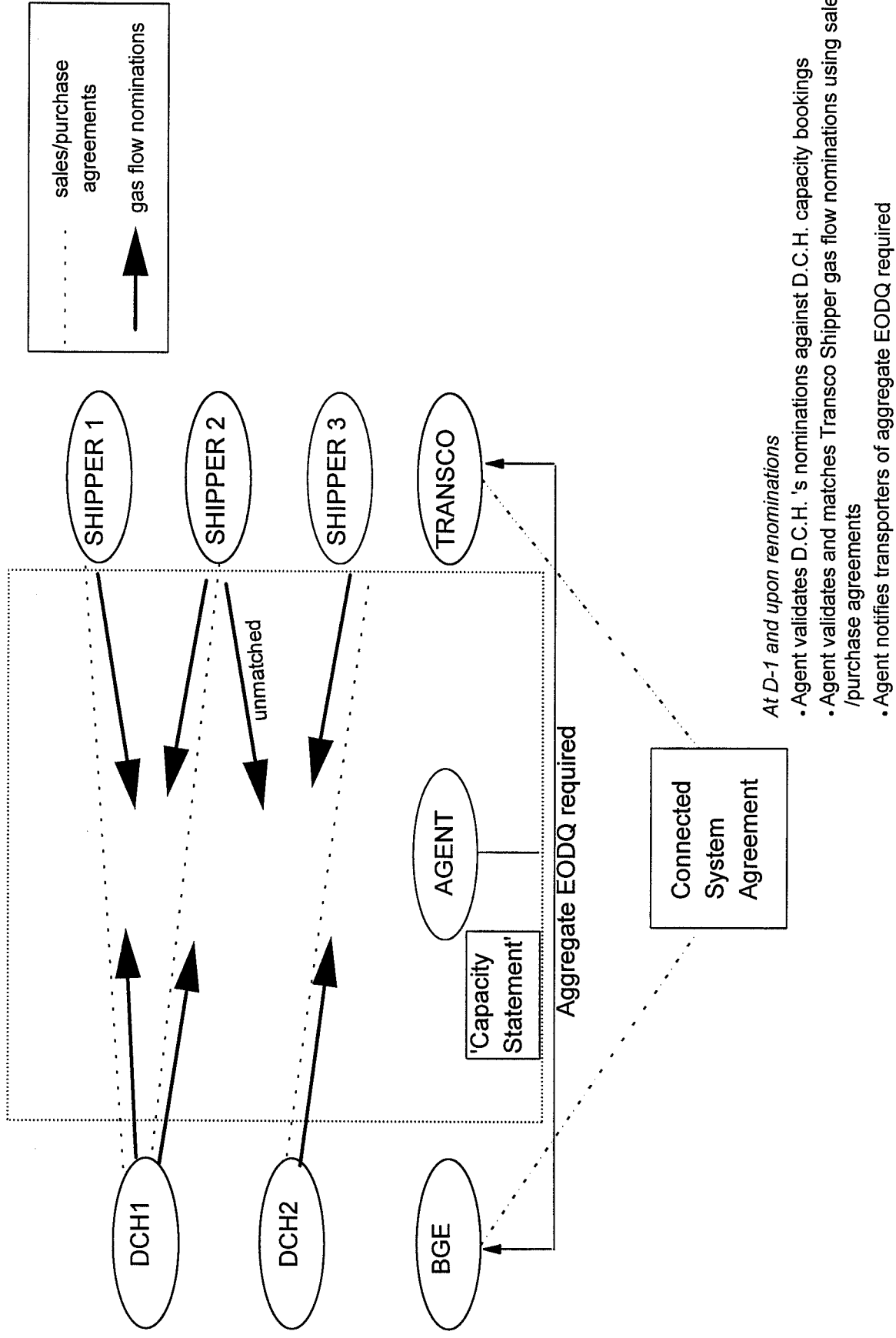
OPTION 2 - CAPACITY BOOKING (D.C.H.'s book and hold Transco capacity)



Prior to gas flow day and upon changes

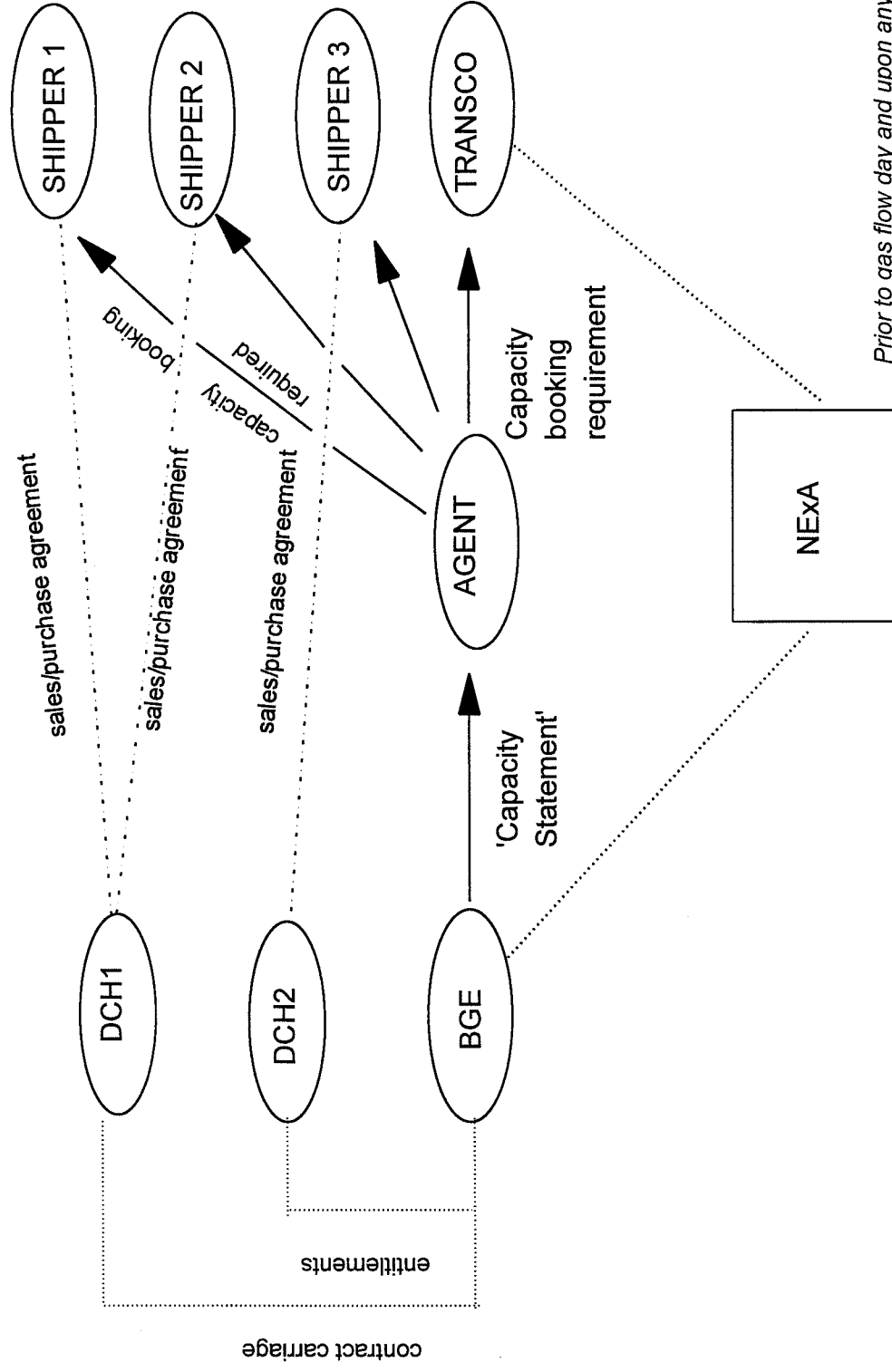
- D.C.H.'s book capacity with Transco, validated (by Agent) against carriage entitlements on B.G.E. line, and in aggregate against the NEXA

OPTION 2 - GAS FLOW NOMINATIONS (D.C.H.'s book and hold Transco capacity)



OPTION 3 - CAPACITY BOOKING

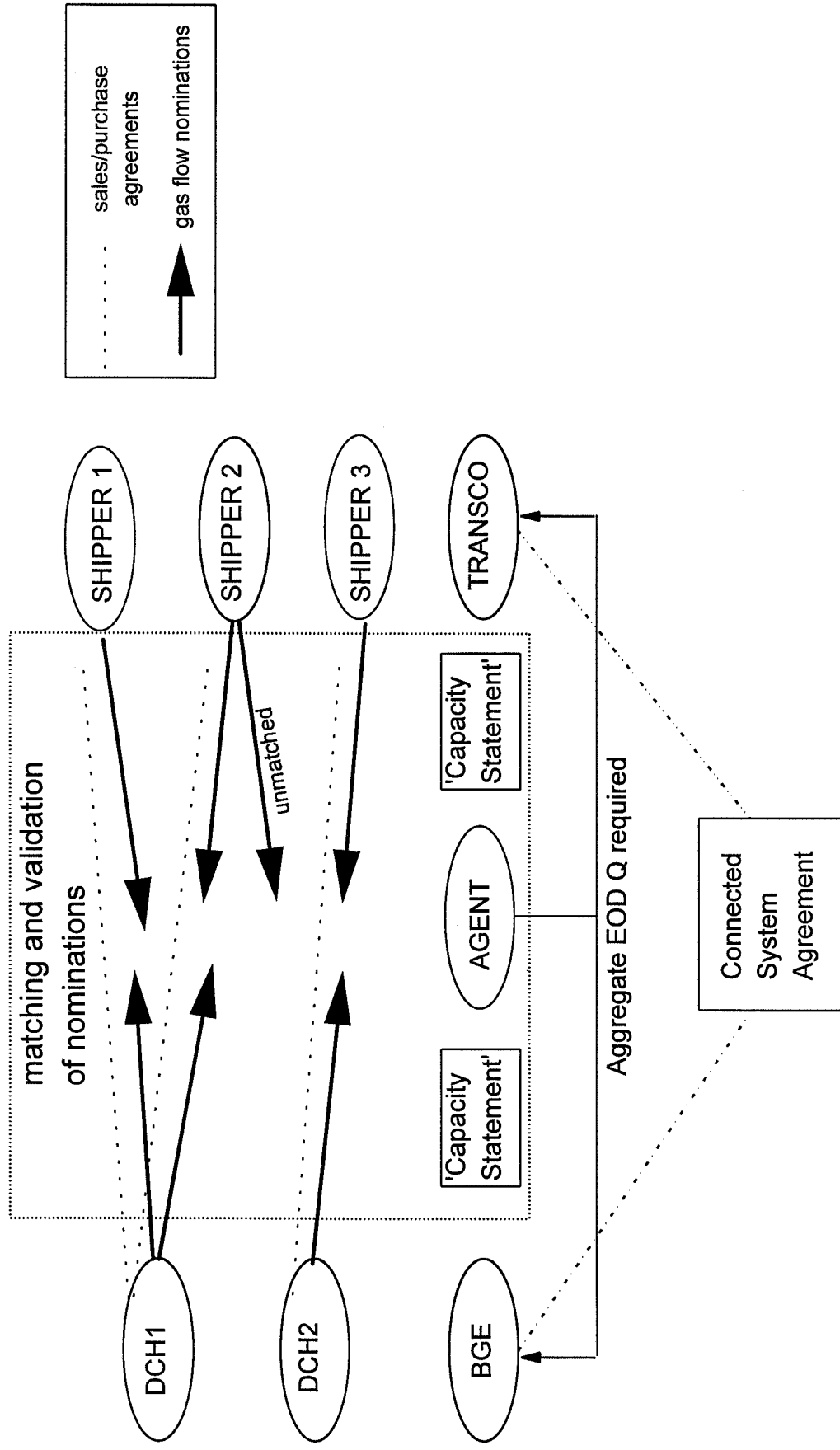
(Transco shippers book and hold Transco capacity as dictated by D.C.H. requirements)



Prior to gas flow day and upon any changes

- D.C.H.'s notify agent of carriage entitlements. Agent validates with B.G.E. (or vice versa)
- D.C.H. notify agent which Transco shippers they are purchasing from, the quantities required (i.e. what capacity the Transco shippers require)
- Agent notifies Transco shippers and Transco of capacity booking required (precise details of which party inputs data into UK LINK to be determined)

OPTION 3 - GAS FLOW NOMINATIONS (Transco Shippers book and hold Transco capacity)



At D-1 and upon renominations

- Agent validates D.C.H.'s nominations against carriage entitlements
- Agent validates Transco shippers nominations against Transco capacity booking
- Agent ensures matching nominations upstream and downstream, and notifies transporters of aggregate EODQ requirement