

Draft Modification Report
Amendments to Operating Margins Pre-emption Rights at LNG sites
Modification Reference Number 0558
Version 2.0

This Draft 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 Modification Proposal was as follows:

"The proposed changes are designed to avoid any impact to Transco's Safety Case by maintaining Transco's unlimited "pre-emption" rights. The changes would achieve this by allowing Transco to secure rights to capacity which holds another Users' gas by a form of tender, which would thereby indicate the value of any such pre-emption which Transco decide to exercise.

They are also designed to admit the prospect of varying OM requirements in future years while other Users may have multi-year LNG capacity bookings.

The Proposal would make three changes –

- i. Initially Transco would have "free" pre-emption rights in respect of LNG capacity up to a quantity at any site which is the greater of:
 - a) the amount of OM gas held in that store at 1 March and
 - b) the capacity at that site available to all Users for the ensuing Storage Year less the total quantity of gas held in store in firm bookings at 1 March by LNG Users other than by Transco for OM purposes.

This allows the OM Manager free access to all empty or un-booked capacity (case (b) above). Also, in any case where the capacity available to Users is reduced (as with Grain this year) case (a) ensures that the quantity available to the OM manager is never less than his inventory at that storage facility

- ii. If Transco determine that the above is insufficient for the following Storage Year's OM needs, then Transco would be given scope to "buy" extra pre-emption rights. To this end, Transco would be entitled to publish a tender to buy gas-in-store bundled with capacity rights for the remainder of the current Storage Year. By publishing such a tender Transco would have pre-emption rights to the capacity as defined in (i) and also to the additional capacity holding gas-in-store acquired in the tender process. This places no limit on the extent to which Transco may choose to increase their OM booking for the following Storage Year. The gas acquired would become OM gas in store at the date of acquisition and would reduce the procurement requirements for the ensuing year. This process would mean that a "market price" is determined for the capacity and gas which has to be released to enable the OM booking to be increased. Users should have not less than 7 working days to formulate responses to the tender.

- iii. The Code rules need to accommodate the possibility that Transco want additional capacity for OM purposes and publish a tender as above but Users holding such capacity decline to offer sufficient capacity in the tender. In this case, maintaining the integrity of Transco's Safety Case requires that Transco should have the right to such additional pre-emption as is needed after the tender, irrespective of the impact on other Users and on any ongoing contracts Users may have with Transco LNG.

Thus where Transco seek additional space for OM use, they would in due course need to procure extra gas for this space. Where (but only where) there would be a conflict with other Users' holdings of gas in store, the proposed process advances the gas procurement to precede any release of LNG capacity to other Users, with the aim that by the time of that release of capacity sufficient capacity would normally remain available to accommodate the total amount of gas.

The above changes would require that any long-term contracts between Transco LNG and their Users admit that capacity may have to be capable of being "clawed back" if the capacity left available after Transco's OM requirements are secured is insufficient for Transco LNG to honour all ongoing contracts. This has to be borne in mind in structuring future relationships between Transco LNG and their customers but is not a Network Code issue. Also, it is an issue to be addressed whether or not this Modification is implemented."

2. Transco's Opinion

Transco does not support implementation of this Modification Proposal for the following reasons:

- The Network Code Operating Margins rules primarily concern the procurement, use and if necessary the disposal of Operating Margins Gas. Procurement of storage capacity is governed by Transco's Gas Transporters Licence, and incentive arrangements are in place. Transco does not believe that a Network Code Modification Proposal is the appropriate means of introducing further incentives which would affect Transco's exposure under its existing Licence conditions.
- Whilst the Proposer emphasises the fact that a holder of storage capacity might become a "distressed seller" in respect of gas-in-storage, there is no reason to believe that requiring Transco to purchase storage capacity prior to the Storage Year would address this perceived short-fall in sales. Transco's purchase of storage capacity in such circumstances would be unlikely to accurately compensate the User but would either under or over compensate. Transco is therefore surprised that the proposed compensation mechanism does not directly address the price differences when these could be determined by reference to WACOG or SAP data.
- OM storage capacity requirements reflect the underlying scenarios which have been discussed with Users. As demand tends to increase each year and Transco's pipe-line system is extended to reflect this, it is inevitable that even the same scenarios would lead to calculation of different OM requirements. Transco also contends that it is appropriate to review the underlying scenarios from time to time as its understanding of the risk

elements within its security of supply strategy are refined. Implementation of this Modification Proposal would essentially incentivise Transco to not pursue development of its security strategy to meet changing patterns of supply and demand.

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

The Proposer does not specifically refer to the relationship between implementation of this Modification Proposal and the facilitation of the relevant objectives. In referring to the risk of Users becoming "distressed sellers" it is assumed that the case for implementation is based upon the objective of securing effective competition between relevant shippers. Transco, however, believes, that such risks should be viewed in the context of maintenance of supply security and that there are more appropriate methods of ensuring that sellers of gas-in-storage achieve a fair price for that gas.

Transco does not believe that implementation would be consistent with Transco's efficient discharge of its obligations under its Licence, particularly those security of supply obligations that are met by Transco's procurement of OM capacity and gas.

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

Transco is unaware of any implications that implementation would have on the operation of the System.

b) development and capital cost and operating cost implications:

Implementation of this Modification Proposal would be expected to have operating cost implications as Transco reviews its System Reserve requirements each year.

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:

As implementation of this Modification Proposal would change the cost assumptions on which Transco's System Reserve Incentive Target is based, it may be appropriate for Transco's Licence to be modified in order to amend this target.

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

Transco is unaware of any implications that implementation 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

As implementation would open the possibility of Transco trading-in additional storage capacity, its level of contractual risk would be expected to increase.

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

Transco would need to develop its computer systems to manage an additional trading process but these systems implications would not be expected to be major.

7. The implications of implementing the Modification Proposal for Users

Implication of this Modification Proposal would allow Users to sell to Transco storage capacity and gas-in-storage at facilities prior to the Storage Year in the event that Transco increases its Operating Margins bookings.

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

The Storage Operator would be expected to slightly increase its volume of capacity and gas-in-storage trades.

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

There would be a minor extension to the contractual relationships between Transco and Users due to the additional tenders required to give effect to implementation of this Modification Proposal.

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

Advantages

- Implementation would potentially yield additional income for Users of Storage Capacity, if Transco issued tenders for purchase of additional storage capacity and gas-in-storage, in order to meet an increased Operating Margins requirement.

Disadvantages

- Implementation would increase Transco's cost exposure in its role of managing System Reserve.

- The additional income for a User would not necessarily compensate for that User's exposure as a distressed seller of storage capacity.

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

Transco invites representations to this Modification Proposal.

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

Transco is unaware of any such requirement.

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

Transco is unaware of any such requirement.

14. Programme of works required as a consequence of implementing the Modification Proposal

A programme of works for the minor system changes would be required if this Modification Proposal were implemented but these have not been identified at this stage.

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

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

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this Modification Proposal.

17. Text

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: