

URGENT Modification Report
Publication of capacity forward and option costs
Modification Reference Number 0561
Version 2.0

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, therefore an urgent decision about the information (if any) that should be published regarding the results of these tenders is appropriate. In addition this information may be relevant to shippers ahead of the forthcoming MSEC auction which are currently scheduled for early August.

Procedures Followed:

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

Issued to Ofgem for decision on urgency	28 June 2002
Proposal agreed as urgent	28 June 2002
Proposal issued for consultation	28 June 2002
Close out for representations	8 July 2002
Final report to Ofgem	10 July 2002
Ofgem decision expected	12 July 2002

1. The Modification Proposal

Transco has recently developed new capacity management tools and has held tenders for shippers to sell forward and option contracts for monthly system entry capacity back to Transco. Transco should be obliged to publish certain information (weighted average price, volume contracted, volume offered, number of bidders and number of successful bidders) following each tender. Transco should also be obliged to publish on a daily basis the volume and weighted average price of any capacity options exercised on that day.

2. Transco's Opinion

Transco does not support implementation of this Proposal.

Transco is operating in an incentivised arena where it shares both risk and reward with Users and therefore it is in the interests of all parties that it can carry out its activities as commercially and efficiently as possible. Ofgem has proposed that Transco's Licence should require Transco to act in an economic and efficient manner and Transco does not believe that publishing the information proposed would be "economic and efficient". When tendering for option and forward contracts, Transco is purchasing secondary capacity and is thus acting in a similar manner to a shipper or trader, neither of which have to publish any information.

Transco does not consider it appropriate for it to be singled out and required to provide information concerning its actions in the 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.

Transco considers that in an incentivised regime it would be neither economic nor efficient be obliged to publish data that could act as a guide for price setting by counter parties. Transco believes this is supported with the pricing guidance provided by Ofgem in its letter 'NTS Capacity constraints and conduct in the buy-back market' (18 October 2000). In a competitive market, a shipper would not be able to influence the market price for buy-backs and would simply bid to reflect opportunity cost. Transco believes that there would be merit in considering a proposal that all Users should be required to publish their opportunity costs, which Ofgem has suggested are directly relevant to determining the value of secondary capacity.

Transco is also concerned that publication of the requested data could expose confidential information about individual parties, for example 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 are in the position of a dominant seller and would be expected to result in them pricing their offers accordingly. As a minimum, therefore, Transco would suggest that were the Proposal to be implemented, aggregated information should only be published for transactions involving a minimum of six parties.

Transco also considers that publication of daily statistics (of options called) could prove to be counter productive because it may be construed as providing a signal regarding the proximity of capacity constraints. It may also increase the potential for gaming by increasing flows onto the system and increasing spot offer prices to take advantage of Transco's perceived distress.

If this Proposal is implemented and prices subsequently increase, then Transco would be minded to raise a further Modification Proposal to return to the status quo.

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

Transco does not believe this proposal would further the relevant objectives, as it considers that the entry capacity regime would operate less efficiently and economically following implementation.

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."

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

Transco has not identified any implications for the operation of the System.

b) development and capital cost and operating cost implications:

No significant operating costs are anticipated, but higher buy-back costs would be likely.

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 set out in Ofgem's final proposals for System Operator incentives.

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

There are no such consequences.

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 has 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.

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

There are no such implications.

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.

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

Where Transco has already entered into option or forward contracts with Users, this proposal would change the basis of those contracts.

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

Advantages:

- Users would have access to additional information

Disadvantages:

- Commercially confidential information could be published
- Prices for forward and option contracts could increase to reflect what Transco will bear rather than Users' valuation of capacity

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

Eleven representations were received:

Agip (UK) Ltd (Agip)
British Gas Trading Ltd. (BGT)
TotalFinaElf Gas & Power Ltd. (TFE)
Statoil (UK) Ltd (Statoil)
Shell Gas Direct (Shell)
Powergen UK Plc. (Powergen)
BP Gas Marketing Ltd (BP)
SSE Energy Supply Ltd (SSE)
Entergy-Koch Trading Europe Ltd (Entergy)
AEP Energy Services (AEP)
LE Group (LE)

Nine respondents (TFE, Agip, BGT, Shell, Powergen, BP, Entergy, AEP, LE) support the proposal.

One respondent (SSE) did not express a definitive position in respect of this modification proposal.

One respondent (Statoil) does not support the proposal.

11.1 Market Liquidity

Powergen, SSE, TFE, Agip, Entergy and Shell commented that they believe the publication of information regarding option and forward contacts would increase liquidity in the buy back and secondary market. Agip stated they believe “*that greater information transparency will enhance shippers’ understanding of the market and will lead to greater participation and liquidity in the forward, option and buy back markets*”. Powergen considered that making this information available would “*significantly improve liquidity in the secondary capacity*”.

market”. SSE commented “if there is greater competition for acceptance in the tender process, the price of capacity management tools should go down”.

Transco Response

Transco does not agree that greater information will necessarily lead to lower prices; it considers that lower prices and greater efficiency would require reduced “pricing power” and increased liquidity. Pricing power for Users offering capacity is mostly likely to arise if Transco is required to release information that will signal the periods when it is likely to be a distressed purchaser, for example the publication of option exercise information or ex-ante information about tender results. Transco’s distressed position is driven by the nature of its capacity management obligations as a prudent operator which require that Transco cannot avoid going to market; this situation does not apply to Users. Transco believes that any obligations to publish information, regarding secondary activity in the capacity market, should apply equally to all parties in the capacity market.

The issue of pricing power could be mitigated by deep and liquid markets, which Transco contends 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 is concerned that respondents may be trying to gain access to information about activities at St Fergus which may be used to create greater costs for capacity holders at other entry points.

11.2 Monitoring of Transco

Four Users (TFE, BGT, Entergy, Shell) supported the provision of information to enable Users and Ofgem to monitor Transco’s use of forward and option contracts. BGT and Shell also pointed out that Users bear a proportion of the costs. Shell stated that *“it is essential that as much information as possible is made available as shippers (and customers) ultimately bear the costs of the monopoly operator of the system”*.

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 different approaches to system management issues, consequently it will require a reduction in prescriptive arrangement including information provision. Transco has provided, and expects to continue to provide, details of all tenders to Ofgem and does not consider that Users have a role to play in monitoring Transco’s trading activities; information about trades between other parties are not published.

11.3 Commercial Confidentiality

Statoil and Shell raised concerns about commercial confidentiality and the release of information where only a small number of Users tendered. Statoil considered that there is *“...some requirement for data to be published at an aggregate System wide level but do not think that any greater granularity should be applied as it could compromise the*

confidentiality of Users who strike the contracts and therefore act as a deterrent to market entry”.

Transco Response

Transco welcomes support from Users about its concerns with regard to commercial confidentiality, and agrees with Statoil that publishing detailed information could represent a breach of confidentiality and act as a deterrent to Users taking part in buy back tenders.

11.4 Information for Auctions

BP and Entergy expressed the view that information about option and forward contracts would facilitate valuation of capacity in the forthcoming MSEC auctions, and Entergy also believes it would assist in developing bid strategies for the long term auctions and stated that *“shippers will need as much information as possible given the increased risk of mispricing long term positions”.*

Transco Response

Transco expects to offer for sale firm entry capacity up to the published baseline quantities. Users that purchase firm entry capacity have a right to nominate gas flows up to the level of that capacity. Publication of option and forward contract costs will not change the probability of a User obtaining firm entry capacity at a price, and no mechanism has been suggested in responses whereby such information would change the underlying valuation placed on capacity by Users. It could however effect the valuation for those Users who might seek entry capacity for the purpose of offering entry capacity back to Transco at a profit. Transco does not believe that such activity can add to the efficient operation of the pipeline system and also contends that this is likely to drive up capacity management costs.

11.5 Other Issues

BGT considered that further information should be provided, including *“the number of days or part periods accepted by Transco”.* This was in contrast to Statoil who considered that information should only be available at the system-wide level.

Statoil pointed out that this issue is under consideration as part of the Procurement Guidelines and System Management Data Adjustment Methodology.

Both Shell and SSE considered that the issue would merit further discussion.

Transco Response

Transco welcomes Statoil’s comments about the inclusion of information in the Procurement Guidelines, and agrees that this debate would be better placed as part of development of that document. Ofgem has indicated in its letter of 10th July 2002 regarding Supplementary Statements, that it considers information provision to be an area that should be included in the Procurement Guidelines.

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

There are no additional works required.

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 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

TRANSITION DOCUMENT PART II

Paragraph 8.1.2.A add sub paragraph 6 as follows:

6. Where Transco has entered into Capacity Management Agreements with more than six Users, it shall publish on the following Business Day (or as soon as reasonable practicable thereafter):-
 - (i) the weighted average price for the surrender of Firm System Entry Capacity pursuant to such agreements;
 - (ii) the aggregate quantity of Firm System Entry Capacity that was surrendered pursuant to such agreements;
 - (iii) the aggregate quantity of Firm System Entry Capacity that was offered for surrender by Users.
 - (iv) without identifying individual Users, the number of Users who offered to surrender Firm System Entry Capacity pursuant to Capacity Management Agreements in respect of that Day and the number of Users who entered into Capacity Management Agreements in respect of that Day;
 - (v) where such Capacity Management Agreements include an option in favour of Transco that capacity is surrendered by a User, Transco shall, where it exercises such option, on the following Business Day (or as soon as reasonably practicable thereafter) publish the volume weighted average price for the surrender of Firm System Entry Capacity pursuant to such options agreements.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation 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 **0561**, version **2.0** dated **26/07/2002**) 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 (whether such approval is actual or deemed by effluxion of time) 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, had it not been repealed, would 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) or 2(2)(b)(ii) 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.