Modification Report
Revision to entry capacity overrun charges
Modification Reference Number 0653

Version 3.0

This 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 Proposer stated that :

"The current entry capacity overrun charges should be changed to safeguard Users from excessively penal overrun charges caused by an erroneous bid being accepted in the AMSEC, RMSEC and DSEC auctions. In order to maintain transparency and simplicity the highest price from each of the firm capacity auctions (LTSEC, AMSEC, RMSEC and DSEC) should be averaged and then multiplied by a factor of 8, thereby "smoothing" out the effect of any erroneous bids accepted in any of the firm capacity auctions."

2. Transco's Opinion

Transco does not support this Proposal. It recognises that the issue of determining an appropriate level of entry overrun charges has periodically been the subject of debate. It is acknowledged that the level of overrun charge on any day needs to maintain an appropriate incentive on shippers to pre-book capacity to allow Transco to operate its pipeline system in an efficient manner.

Network Code Modification Proposal 0500 (Long Term Entry Capacity Allocation) which was implemented in October 2002 amended the daily product overrun marginal component from an "average price" basis to a "marginal price" basis, while retaining the multiplier at 8. Analysis of overrun charges since the implementation of Modification Proposal 0500 (Long Term Capacity Allocation) indicates an increase in both the overrun charges and overrun quantities suggesting a change to marginal prices has not significantly increased incentives on Users to pre-book entry capacity. Transco is concerned that any change to an averaging of marginal prices may reduce the effectiveness of the overrun mechanism thus further increasing the propensity for breaches of entry capacity.

Transco recognises that acceptance of a single high priced bid could set an overrun price and that the high priced bid could have been offered either because it is reflective of a shipper's value for entry capacity or a bid is submitted in error. It is only the latter example that provides a case for averaging. Transco considers that this proposition fails to address how the relative weighting between AMSEC, RMSEC and DSEC is determined and also does not take into account the impacts of having relatively low reserve prices for DSEC. For example, should DSEC have an equal weighting with AMSEC and RMSEC despite a tendency to release very low volumes in DSEC auctions. Furthermore, Transco is concerned that the proposed overrun would give an equal weighting to DSEC despite it having a considerably lower reserve price.

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

In Transco's view, implementation could lead to a disincentive on shippers to pre-book entry capacity, which could impair Transco's ability to manage gas flows at entry via its capacity management tools, thus impeding the efficient and economic operation of the pipeline system.

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

a) implications for the operation of the System:

The proposal could lead to a reduction in overrun charges which could lead to an increase in the likelihood of entry gas flows exceeding the aggregate capacity holdings. This could result in an increase in the use of TFA's (Transportation Flow Advice) at affected ASEPs.

b) development and capital cost and operating cost implications:

Implementation would be expected to lead to systems development costs, although the extent of such costs would not be expected to be significant.

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:

The development costs would be part-funded by the SO licence incentive.

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

No consequences are anticipated.

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

No consequences are anticipated.

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

The proposal to amend the overrun component relating to firm capacity auctions from a "marginal price" to an "average of marginal prices" requires new functionality within Transco's systems, where the overrun multipliers are held and the calculation of overrun prices is processed. As the proposed implementation date of 1 April 2004 is close to the planned replacement of the RGTA Capacity system with Gemini, the extent of any systems changes and whether the Proposal would result in systems changes to RGTA, Gemini or both would depend on the precise timing of the "handover" from RGTA Capacity system to Gemini. The latest expected date for Gemini delivery is 1 June 2004.

Transco has not been advised of any implications for User's computer systems.

7. The implications of implementing the Modification Proposal for Users

Users will be exposed to a lower level of overrun charge which could lead to an increased use of TFAs to manage the system.

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

Due to a reduction in the incentive on Users to restrict their entry gas flows to their entry capacity entitlements, Terminal Operators may see an increase in the use of TFAs by Transco.

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

No such consequences are anticipated.

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

Advantages :

Basing overrun prices on an average of marginal prices from the different auction types, as opposed to a single marginal price basis would be expected to avoid any price spikes arising from a single auction.

Disadvantages :

A reduction in incentives to avoid overrunning due to averaging of overrun prices.
A reduction in the level of overrun charges could lead to an increase in the use of TFAs by Transco.

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

Representations were received from the following eight respondents :

Powergen	(PG)
EDF Energy	(EDF)
ConocoPhillips (UK)	(CP)

Statoil (UK)	(STUK)
RWE Innogy	(RWE)
Total Gas & Power Ltd	(TGP)
British Gas Trading	(BGT)
Scottish & Southern Energy	(SSE)

Of these, two (CP,STUK) expressed support for the Proposal, two (PG,EDF) expressed support in principle or qualified support, three (RWE,TGP,BGT) did not support the Proposal, and one respondent (SSE) gave no overriding view.

General

Those respondents expressing support for the Proposal argued that it was appropriate that erroneous bids should not be included that would otherwise set excessively high overrun charges. There was a consensus expressed that amending the overrun component from a marginal price to an average price would 'smooth' out and avoid distortion from any erroneous bids that bore no relation to cost or market value.

EDF suggested that the Proposal would reduce price spikes in the charges to Shippers who are bringing gas to the market. It also argued that very volatile System Entry Charges could have a knock-on effect of increasing the cost of capacity management to Transco.

CP expressed disappointment at Transco's lack of support for the Proposal and stated that Transco's comments in the Draft Modification Report (in respect of the level of overrun multiplier) were misrepresentative which may have influenced participants' views. SSE suggested that any anticipated reduction in overrun charges was not reasonable justification for retaining a flawed methodology. SSE noted Transco's concerns regarding average pricing but argued that as the proposed charge was still calculated from the highest price from each of the auctions and multiplied by a factor of 8, it would expect this to limit any concern.

Those respondents not in support of the Proposal suggested that it was important to retain the incentive properties of the current overrun charge. Adopting an averaging approach to marginal prices it was suggested, would weaken incentives on shippers to procure capacity ahead of gas flow, a view that was also shared by PG (while supporting the Proposal in principle). RWE commented that given the number of opportunities there were to procure capacity in the various auctions, shippers choosing to overrun should face a penal charge.

EDF Energy made reference to the removal of an average methodology and its replacement by a marginal methodology through Modification Proposal 500, "Long Term Capacity Allocation".

While expressing sympathy with the views put forward by the Proposer, that the inclusion of a marginal price which was the result of an error could lead to an excessive rate, BGT argued that the Proposal could also remove an extreme price where this had been a result of a real and necessary action. It added that the overrun charge should be established at a level where it provides an appropriate incentive and is representative, or a least a reasonable proxy, for the actual costs incurred as a result of the overrun. SSE also stated that they would not expect marginal prices to be as a result of erroneous bids in the majority of circumstances. RWE acknowledged that a case could be made for the removal of erroneous bid prices, but did not believe that an ad hoc mechanism should become part of the general mechanism for determining the overrun charge. It stated that it would support a separate mechanism to effect this correction, providing erroneous bid prices could be unambiguously identified. PG also accepted that Users may be potentially hit by excessively high overrun charges where erroneous bids had been accepted.

Volume Weighting

Two respondents (SSE,STUK) argued that there may be merit in including some form of volume weighting to the averaging process and to take account of the lower reserve prices for DSEC to avoid other distortions in the calculation of the overrun price.

CP commented that in recent firm entry capacity auctions there had been very little depth of price differential, between the highest and the reserve price at all terminals, with the exception of St Fergus. Therefore, in its view, the volumes sold at any type of auction and the highest price achieved need not be weighted to accomplish a "fairer" overrun value. CP also expressed surprise at Transco's comments in this regard because this aspect was not considered necessary during the implementation of the current overrun regime. In fact under the current regime a small volume of capacity could be sold by Transco in the Daily System Entry Capacity auction at a very high price, possibly erroneously, which would set the overrun charge rate to an extremely high penal level. It further added that the current regime may have benefited from a weighted pricing approach.

Other

BGT noted Transco’s statement that since the adoption of a charge calculated by 8x marginal price, implemented by Modification Proposal 500, there had been an increased number of overruns. However, CP argued that with an increase in the aggregate flow onto the system, i.e. for gas year '02/'03 flow was 925 million kWh in comparison to 873 million kWh for the previous gas year, an increase in overruns should be expected. It further stated that if Transco's analysis suggested there was excessive and consistent overrunning at terminals, then those Users should be identified to Ofgem. However, in its view the case was more likely to be one of after the day allocation or an oversight on the day, causing occasional overruns by numerous parties. As a qualification to its support for the proposal, PG requested that there was adequate monitoring of overrunning at terminals to ensure that Users were not overrunning to a greater extent as a direct result of the Proposal.

CP suggested that many of the overruns would be on days when the system was not constrained, but would be charged at an unnecessarily penal rate under the current regime.

In respect of effects on secondary trading, CP suggested that on days of system constraint, the cost of entry capacity on the secondary market may be influenced by the potential overrun charge rate, and by maintaining a penal charging methodology Transco and other Users may have to endure exceptional high prices for entry capacity on such days. However, TGP suggested that implementation of the Proposal would reduce incentives to trade in the secondary market as overruns would be less penal and that the Proposal, although reducing the effects of onerous prices, would not benefit the regime.

CP further argued that the entry capacity market was substantially more liquid than it was a year ago and has further deepened by recent changes to the daily capacity auctions. In its view this provided no incentive on Users to intentionally overrun at any terminal. CP suggested that as firm entry capacity may be secured at a zero reserve price within the day, any charge attributed through an overrun would be in excess of this and therefore, any number of arbitrary multiplier may be selected to incentivise Users to purchase sufficient entry capacity, without the need for it to be excessively penal.

EDF Energy requested confirmation that only option (a) in the Network Code clause 2.12.3 would be amended to reflect the proposed solution. It requested that options (b) to (d) which relate to the average accepted offer price; the average accepted forward price; and the average accepted exercise price remain as they are.

Transco's Response

Transco welcomes the responses received and notes the wide range of views provided on the Proposal which reflects the range of opinion held by the industry on determining an appropriate level of overrun charges. Having acknowledged the comments put forward by respondents, and the increase in overrun quantities since the introduction of Modification Proposal 0500 (Long Term Capacity Allocation) , Transco remains of the view that implementation of the Proposal would not further Transco's relevant objectives and therefore does not support the Proposal.

In respect of the comments put forward on erroneous bids, Transco agrees that it is inappropriate for such bids to set high overrun charges. The introduction of a system that could identify those bids that were submitted in error would require a degree of interpretation and the issue of agreeing a set of rules and a process that could exclude such bids has proved difficult to resolve in the past. Transco would support the comments put forward by respondents that the suggested methodology set out in Proposal could also exclude daily prices that were set that reflected actual capacity management costs incurred. Therefore, in its present form the Proposal, in addition to removing the effect of erroneous bids, would ultimately deliver a reduction in the overrun charges by the introduction of the averaging approach, an outcome that Transco does not support.

In respect of the level of overrun quantities experienced since the introduction of Modification Proposal 0500, and in response to the comments put forward by CP, Transco can advise that the increase in annual overrun quantities, both in financial terms and energy terms, has been around five-fold (i.e. the level of annual overrun costs increased from £495k to £2.6m. The annual overrun quantity increased from 346 GWh to 2020 GWh). Therefore such an increase would be attributed to more than the (6%) increase in aggregate flow quantities into the system seen during the same period, as quoted by CP. Transco would be concerned with any reduction in the overrun charges, given the significant rise in overrun occurrences experienced from 1 October 2002 onwards.

In respect of CP's comments on any misrepresentation of the Proposal, Transco accepts that in the Draft Modification Report it had intended to state a “reduction in the overrun charge” rather than a “reduction in the overrun multiplier” and apologises for any misrepresentation of the Proposal. In light of the comments received, however, it would appear that this has not misled respondents’ understanding of the Proposal.

Transco has noted the comments put forward in support of any weighting between prices from different auction types. Transco notes that the proposed overrun calculation involves a simple averaging of the highest bids accepted from each of the four auction types. Transco agrees with those comments in support of the use of some form of weighting, particularly as the vast majority of entry capacity is sold on a long term basis, whereas the proposed methodology would give equal weigthing to prices associated with the daily product. Transco believes that in deriving an appropriate overrun methodology a balance needs to be struck between ensuring the correct weighting whilst avoiding undue systems complexity. Transco would be willing to undertake further analysis on recent overrun trends and to facilitate discussion at future Industry meetings on different options for overrun charges.

Transco can confirm that the Proposal if implemented would only amend option (a) in the Network Code clause 2.12.3, and would leave options (b) to (d) unchanged.

Transco acknowledges that instances of overruns can occur on non-constrained days when the value of entry capacity could arguably be less than on days when the system is constrained. However, in Transco's view, overrun prices generally are lower on non-constrained days than on those days when system constraints have occurred. In addition, if the system is unconstrained Users can mitigate the risk of overrunning by securing relatively low priced additional capacity on the day.

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

No such requirement is envisaged.

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

Not applicable.

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

As no changes to UK Link are envisaged, a Programme of works is not required.

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

Transco envisages that implementation could be delivered via changes to the RGTA Capacity System by 1 April 2004, subject to the timing of an Ofgem decision.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not support implementation of the 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:

Mike Calviou
Commercial Frameworks Manager
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 **0653**, version **3.0** dated **19/12/2003**) 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 **3.0**.

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 <u>(whether such approval is actual or deemed by effluxion of time)</u> 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, <u>had it not been repealed, would</u> 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) <u>or 2(2)(b)(ii)</u> 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.