

Transco, shippers and other interested parties  
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Dear Colleague,

**Modification proposal 620 'Publication of additional forward and option surrender of entry capacity tender information'**

Transco raised modification proposal 620 '*Publication of additional forward and option surrender of entry capacity tender information*' on 7 March 2003.

Ofgem has considered the issued raised and responses received to this proposal and has decided to direct Transco to implement this proposal because Ofgem considers that it will better facilitate the relevant objectives of Transco's network code.

In reaching our decision we have given due consideration to our statutory duties under the Gas Act 1986 and amended standard condition 9 of Transco's Gas Transporter (GT) licence.

**Background**

*Entry capacity regime*

Transco has offered firm monthly system entry capacity (MSEC) rights to its National Transmission System (NTS) for sale via six-monthly auctions since September 1999. In addition to offering MSEC, Transco also releases firm and interruptible capacity on a daily basis where there is additional capacity available. MSEC auctions were held in February 2003 and covered a period from 1 April 2003 to 30 September 2003. The first annual monthly system entry capacity (AMSEC) auctions are due to be held in August 2003.

Following Ofgem's approval of modification 0500, '*Long Term Capacity Allocation*', Transco also makes available quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use. The first long-term auction for the sale of quarterly entry capacity rights from 2004 to 2017 was held in January 2003.

*Entry capacity buy-back*

In the event that expected flows exceed both the capability of the system at an entry point and the amount of capacity held by shippers at that terminal, Transco must act to reduce the amount of available capacity. This is achieved in the first instance through the scaling back of interruptible capacity and subsequently by the purchase, by Transco, of firm entry capacity rights from shippers at market determined prices. In this context Transco is now free to contract for capacity ahead of the day with a view to reducing the total costs of capacity management.

Transco also has financial incentives to manage efficiently the costs of entry capacity buy-backs. Under these incentives (included in its GT licence), Transco faced an £35 million annual target level for the period 1 April 2002 to 31 March 2003 and now faces a £10-20 million target for 1 April 2003 to 31 March 2004. Transco is rewarded for performance below target and

penalised for performance above target. Transco's potential revenues and costs under this incentive are subject to sharing factors as well as caps and collars that have been set for the first two years of the price control for the period 1 April 2002 to 31 March 2007. The upside (downside) sharing factors are set at 50%(35%). The cap is £30 million and the collar is set at £12.5 million. These incentive parameters will be reviewed by Ofgem prior to 1 April 2004.

#### *Transco's use of forwards and options for buying back entry capacity*

In April 2002, Ofgem accepted modification proposal 0498 '*Capacity forward and option entry capacity management*', which gives Transco increased freedom to use a wider range of tools such as forwards and options contracts for the purposes of entry capacity management. The use of such tools is designed to allow Transco the opportunity to seek to minimise its exposure to buy-back costs.

In September 2002, Ofgem approved the form of Transco's Procurement Guidelines and System Management Principles Statement. These documents were prepared and published as part of Transco's obligations under Special Condition 27 of Transco's GT licence. Transco's Procurement Guidelines set out the kinds of system management services which it may be interested in purchasing in the period until the next statement is due and the mechanisms by which it envisages purchasing, entering into or otherwise acquiring them. These services include entry capacity management services. The System Management Principles Statement sets out the principles and criteria by which Transco will determine, at different times and in different circumstances, which system management services it will use to assist it in the operation of the NTS and for what purpose.

#### *Tendering for forwards and options contracts*

Transco has been tendering for entry capacity forwards and options contracts since April 2002.

The implementation of modification 0561 '*Publication of capacity forward and option costs*' on 15 August 2002 placed a requirement on Transco to publish certain information (weighted average price, volume contracted, volume offered, number of bidders and number of successful bidders) following each tender to sell back entry capacity to Transco through forward s and options contracts. However under this modification, Transco was not obliged to publish price, volume contracted or volume offered information where there had been fewer than 3 successful bidders.

On 23 October 2003 Ofgem accepted modification proposal 0587 '*Prospective publication of further forward and option entry capacity information*'. Under this modification Transco is required to publish specific information following the completion of each forward and option tender held. In relation to capacity forward tenders, Transco is required to publish information for each ASEP and for each day of the Forward Delivery Period tendered for. In relation to capacity option tenders, Transco is required to publish information for each ASEP and for each Option Exercise Period tendered for. Transco is also required to notify participants for each Gas Day (for each ASEP) of the volume of entry capacity options exercised on that Gas Day and the weighted average strike price of the options exercised on that Gas Day.

Modification proposal 0587 was forward looking in nature and did not provide for the release of information relating to tenders that had been completed prior to the implementation date of the proposal.

In this context, on 12 February 2003, Ofgem directed Transco to implement modification proposal 0588 '*Publication of further forwards and options entry capacity information*'. This modification placed an obligation on Transco to publish certain information in relation to all capacity forward and option tenders conducted prior to 11 February 2003, subject to appropriate waivers being obtained from affected users. The modification was retrospective in nature and therefore did not apply to future tender information.

As a result of a drafting oversight, the legal text for modification 0587 did not provide for the release of information relating to tender offers for ASEP/time period combinations which have not been accepted by Transco. Whilst this matter was corrected on a retrospective basis following the implementation of modification 0588, it was not addressed going forward. As such, Transco has raised this modification proposal to enable the release of this information.

### **The proposal**

The proposal provides for the publication of additional forward and option capacity tender information in respect of forward and option tender offers received after 11 February where Transco does not accept any such offers for a relevant ASEP /time period combination. The proposal supplements the provisions of modification 0587.

Under this proposal, for each forward tender held where Transco receives tender offers and enters into forward agreement(s) in respect of an ASEP / forward delivery period combination then Transco would publish the following information for each day of the forward delivery period for the relevant ASEP/ forward delivery period combination:

- The volume weighted average price of valid forward tender offers received;
- The aggregate quantity of firm system entry capacity for which valid forward tender offers are received;
- The minimum price offered in valid forward tender offers received;
- The maximum price offered in valid forward tender offers received;
- The volume weighted average price of forward tender offers accepted;
- The aggregate quantity of firm system entry capacity surrendered pursuant to forward tender offers accepted
- The minimum price paid in respect of forward tender offers accepted; and
- The maximum price paid in respect of forward tender offers accepted.

This information would be published on the business day following that on which Transco entered into such forward agreement (s).

For each forward tender held where Transco received tender offers but does not enter into any forward agreement(s) in respect of an ASEP / forward delivery period combination, then Transco would publish for the relevant ASEP / forward delivery period combination:

- The volume weighted average price of valid forward tender offers received;
- The aggregate quantity of firm system entry capacity for which valid forward tender offers were received;
- The minimum price offered in valid forward tender offers received; and
- The maximum price offered in valid forward tender offers received.

This information would be published within four business days following the last day of the tender or for the period from 11 February 2003 to the implementation of this modification proposal, on the business day following implementation.

For each option tender held where Transco receives tender offers and enters into option agreement(s) in respect of an ASEP /option exercise period combination then Transco would publish the following information in respect of the relevant ASEP /option exercise period combination:

- The volume weighted average of valid option strike prices received;
- The aggregate quantity of firm system entry capacity for which valid option tender offers are received;
- The minimum of valid offered option strike prices;
- The maximum of valid offered strike prices;
- The volume weighted average of accepted option strike prices;
- The aggregate quantity of firm system entry capacity available for surrender pursuant to option tender offers accepted;
- The minimum of accepted option strike prices; and
- The maximum of accepted option strike prices.

This information would be published on the business day following that on which Transco enters into such option agreement(s).

For each option tender held where Transco receives tender offers but does not enter into any option agreements in respect of any ASEP / option exercise period combination, then Transco should publish for the relevant ASEP / option exercise period combination:

- The volume weighted average of valid option strike prices received;
- The aggregate quantity of firm system entry capacity for which valid option tender offers are received;
- The minimum of valid offered option strike prices; and
- The maximum of valid offered option strike prices.

This information would be published within four business days following the last day of the tender or, for the period from 11 February 2003 to the implementation of this modification proposal, on the business day following implementation.

Where Transco exercises one or more option agreements in respect of a gas day Transco would also notify users of the volume of firm system entry capacity exercised at each relevant ASEP on that gas day. This information would be published on the next business day following the gas day associated with the exercise of such option agreements.

### **Respondents' views**

Seven responses were received in relation to this proposal and there was unanimous support for its implementation. A number of respondents noted that this proposal would address the omissions from modification 0587 by ensuring the publication of specific information on all forwards and options capacity tender offers.

Respondents commented that this proposal would bring increased transparency, participation, competition and efficiency in the secondary buy-back process. One respondent commented that by increasing competition the proposal should also reduce buy-back costs.

Respondents also considered that publishing additional information would allow system users to better understand and monitor Transco's system management performance and actions. One respondent considered that an increased understanding of Transco's valuation of capacity would improve liquidity in the secondary markets.

One respondent stated that Transco could be seen as a distressed buyer in the tender process. However it considered that Transco, as system operator, could not be treated as an equal participant and therefore should be required to release additional capacity tender information which would assist in decreasing the costs of capacity in the secondary market. This respondent also stated that if the modification proposal were implemented, it would wish to see the consequences on buy-back costs closely monitored.

One respondent stated that the implementation of the proposal would not lead to an exploitation of Transco's position but would, instead, increase competition in the tender and capacity buy-back process.

Another respondent stated that Transco should not be viewed as any other market participant and, as natural monopoly system operator, it should have different requirements relative to the competitive participants in the market.

One respondent considered that the proposal would further align gas market data release with that seen in the electricity market.

Another respondent stated that it was essential that confidentiality be maintained.

### **Transco's view**

Transco indicated it did not support the proposal. However, it recognised that the proposal will ensure that increased information is released for all forward and option capacity buy back tenders.

Transco considered that an obligation to publish additional information on tender offers imposes an unnecessary and inappropriate obligation upon Transco that does not apply to any other participant in the secondary market. It stated that under its incentive regime, Transco should have discretion in respect of the information it releases for forwards contracting activities.

In addition Transco is concerned that the release of additional tender information may cause changes in participants' behaviour and may discourage participation in forward tenders resulting in greater reliance on the RGTA capacity buy-back mechanisms. Transco considered that the implementation of the modification could result in bidders exploiting Transco's distress which would generate increased costs for shippers. In particular, Transco commented that given the 'low level of competition evident in the secondary capacity market, further information release might better inform participants of the value that they might be able to extract from the regime.'

Transco noted that following the implementation of modification 0587, there had been reduced volumes of capacity offered in subsequent tenders at higher prices. Transco recognised that

may have been due to a number of factors but it commented that the obligatory release of more information would lead to increased capacity management costs for shippers.

Transco considered that this proposal increased the risk associated with the management of entry capacity buy-backs thereby increasing costs for shippers.

On the issue of confidentiality, Transco stated that tenders issued after 11 February have been amended to provide for the additional information requirements envisaged by this proposal thereby removing confidentiality issues.

### **Ofgem's view**

As we stated in our decision letter for modification 0561 and repeated in our decision letters for modification proposals 0587 and 0588, Ofgem believes that the release of capacity forwards and option information to the market will better facilitate competition between shippers in selling back capacity to Transco and, as such, should assist in reducing buy-back costs and promoting liquidity in the secondary capacity market. We therefore welcome this proposal, which realises the full intent of modification 0587.

In particular, Ofgem considers that the more detailed post tender information to be published under this proposal should facilitate competitive entry into the buy-back market and the competitive re-pricing of entry capacity.

As noted in previous letters on the publication of buy-back information, Ofgem does not accept the position as outlined by Transco regarding the degree of commercial discretion it should have with respect to the provision of information. Ofgem considers that, as with NGC, there should be a greater expectation of transparency with respect to Transco's activities given its role as monopoly system operator. Ofgem continues to believe that the need for transparency is even more important given Transco's increased contracting freedoms and participation in forwards markets.

In this respect, Ofgem also considers that shippers and the wider industry and customers have a valid role to play in monitoring Transco's performance under its incentives, because it is customers who ultimately pay for the costs of Transco's system operation activities.

As such, Ofgem considers that this proposal will bring additional transparency to Transco's system operation management and will better enable the industry as a whole to monitor Transco's performance.

### ***Alignment with electricity market***

Transco has argued that NGC uses physical tools in a monopoly procurement role to deal with constraints, whereas Transco uses financial tools within a secondary buy-back market involving other market players.

Ofgem does not accept the distinction made by Transco and considers that both system operators have access to a range of tools that are procured in markets involving other participants (eg energy balancing tools).

Whilst Ofgem accepts that NGC does not undertake tenders to buy back transmission capacity it nevertheless publishes information on the outcome of its tenders for balancing services via its web site. The details of this information provision are specified in NGC's Procurement



Guidelines and include price and volume information and the number of bidders and successful bidders.

Ofgem notes Transco's statement that information on system management service tender submissions is made available on an ex-post basis. Ofgem does not accept this statement and would note that NGC publishes certain information relating to the outcome of the procurement of system management services prior to the relevant balancing period (eg price information on ancillary services contracts that have been entered into).

In any event, as noted previously, in the case of Transco entry capacity, Ofgem considers that it is important that price based information is released to the market ahead of the relevant balancing period to promote competitive re-pricing and market liquidity.

### **Ofgem's decision**

Ofgem considers that this proposal better facilitates the relevant objective in amended standard condition 9 of Transco's GT licence of securing effective competition between relevant shippers and relevant suppliers. This proposal should also assist Transco in managing constraints and minimising buy-back costs through its incentives. Ofgem therefore considers that this proposal will also better facilitate Transco's relevant objective to provide efficient and economic operation of its pipeline system.

If you require any further information in relation to this modification please contact me on the above number or Tolani Azeez on Tel 0207 901 7043.

Yours sincerely,



Mark Feather

**Head of Gas Trading Arrangements**

