

Direct Dial: 020-7901 7437

17 July 2002

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/0549

Dear Colleague,

Modification Proposal 0549 'Summer 2002 Capacity Auction'

Ofgem has carefully considered the issues raised in Modification Proposal 0549 '*Summer 2002 Capacity Auction*'.

Before proceeding to confirm the decision that Ofgem has reached in respect of this modification proposal, Ofgem considers that it is important to clarify some matters surrounding the modification proposal.

In raising this modification, Transco has stated that it considers that the proposal better facilitates the relevant objective of the efficient discharge of its licence obligations and will align the Network Code with the Transco System Operator (SO) incentives as proposed by Ofgem. Ofgem proposed modifications to Transco's GT licence to introduce a revised price control and SO incentives with effect from 1 April 2002. The section 23 notice proposing the modifications was published on 12 April 2002 together with an explanatory note. This is the notice which relates to the final proposals referred to by Transco in the final modification report for this Network Code modification proposal. Ofgem's proposals for Transco's SO incentives are described in Ofgem's Final Proposals document which was issued in December 2001¹ and the explanatory note that accompanied the section 23 notice.²

Ofgem would however reiterate that any decision placed before the Authority under amended standard condition 9 (Network Code) of Transco's GT licence has to be assessed against the criteria set out therein having regard to the Gas Act 1986, the Authority's duties, the licensee's duties and all relevant facts. In essence in respect of this modification proposal, this means that it has to be assessed against the background of the licence and the Network Code as they exist today - not as they may be in the future as a result of a proposed licence modification.

However, while there are circumstances where it may be appropriate to have regard to imminent changes to a licence or regulatory regime in order to assess whether the changes meet the relevant criteria, it is inappropriate to make assumptions about how these could be translated into licence obligations.

¹ *Transco's National Transmission System Operator Incentives 2002-7*, Final Proposals, Ofgem, December 2001.

² *Transco price control and NTS SO incentives 2002-7*, Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence, Ofgem, April 2002.

Ofgem is currently considering the responses that it has received to the section 23 consultation. As such, in assessing this proposal Ofgem has not considered or made any assumptions about the possible outcomes of its consultation on proposed modifications to Transco's GT licence.

Notwithstanding this, having regard to the criteria set out in amended standard Condition 9 of Transco's GT licence, the Gas Act 1986 and all other relevant factors, Ofgem is satisfied that this proposal better facilitates the relevant objectives of the Network Code, in particular, by better facilitating the economic and efficient operation by Transco of its pipeline system and by securing effective competition between relevant shippers and suppliers. The reasons underlying this decision are set out below. Ofgem has therefore decided to direct Transco to implement this proposal.

Background to the proposal

In September 1999, Transco conducted the first auctions for the sale of firm, Monthly System Entry Capacity (MSEC) to the National Transmission System (NTS). The auctions provided for the allocation of MSEC to successful bidders for a period of six months (October 1999 to March 2000). Further auctions for MSEC were held in March 2000, August 2000, February 2001, September 2001 and February 2002. On each occasion entry capacity was sold for a period of six months.

Transco has also conducted auctions for Monthly Interruptible System Entry Capacity (MISEC). The first of these auctions was held in November 2000 for a period of four months (December 2000 to March 2001) and further auctions for periods of six months were held in March 2001 and September 2001.

The current provisions in the Network Code for auctions of entry capacity

The Network Code currently provides for annual auctions of MSEC that must be completed by 31 August in any year. Under the existing provisions of the Network Code these auctions would have the following characteristics:

- ◆ Entry capacity would be offered for sale for the 12-month period from 1 October 2002 to 30 September 2003.
- ◆ 110 per cent of Seasonal Normal Demand (SND) levels of capacity would be offered for sale.
- ◆ There would be five auction rounds, with 25 per cent of the available capacity offered in each of the first four rounds.
- ◆ Bidders would be able to apply for any unsold capacity in the fifth round. The unsold volumes are allocated between terminals on the basis of prices bid, subject to the maximum capability of each terminal (the 'maximum capacity amount', as defined in the Network Code)³.
- ◆ Any entry capacity remaining unsold after the five rounds is made available as an 'off-the-shelf' product, which is sold on a first-come-first-served basis at a fixed price.

³ The fifth round was introduced within the context of an SND-based regime for the determination of MSEC volumes following Ofgem's acceptance of Modification Proposal 0371, '*Shipper Determination of Entry Capacity Profiles*'.

In addition, there would be an auction of MISEC. The volumes made available in this auction would be equal to the 'maximum capacity amount' at each terminal less the volumes of capacity made available in the MSEC auctions.

The February 2002 auctions

On 30 January 2002, Ofgem accepted modification proposal 0499, '*Transition Arrangements for Long Term Capacity Allocation*'. This modification introduced the following arrangements for the February 2002 auctions:

- ◆ MSEC was offered for sale for the six-month period from 1 April 2002 to 30 September 2002.
- ◆ A high proportion of the maximum physical capacities at each terminal were offered for sale.
- ◆ There were four auction rounds, with 25 per cent of the available capacity offered in each round and any capacity unsold in rounds one to three offered in round four.
- ◆ MISEC was not made available.

The arrangements for the February 2002 auctions were introduced into the Transitional Arrangements of the Network Code and do not apply to the auctions due to be held in August 2002.

Capacity period

The provisions of the Network Code originally envisaged that the third set of MSEC auctions, held in August 2000, would allocate entry capacity for a twelve-month period (1 October 2000 to 31 September 2001). However, the capacity period was subsequently shortened to six months following Ofgem's acceptance of modification proposal 0409, '*Review to monthly auction capacity parameters*'. In addition, in respect of the February 2001 auction Transco proposed a move to a twelve-month capacity release period through modification proposal 0444, '*Extend Capacity Period Sold to 12 months in MSEC and MISEC auctions for February 2001*'.⁴ Ofgem however rejected this proposal. In rejecting this proposal Ofgem recognised a number of concerns expressed by respondents regarding uncertainties created by the short period of time available before the commencement of the auctions.

Ofgem has frequently expressed its preference for a move to longer-term auctions in order to provide shippers with a higher degree of stability and certainty regarding the structure of the entry capacity regime. However, all MSEC auctions to date have allocated capacity for a 6-month period only, with moves to 12 month auctions being rejected for a different reasons including aligning the auction year with the gas year, and providing industry participants with time in which to evaluate developments to the regime.

Ofgem notes that separate to this proposal, Shell Gas Direct has raised modification proposal 0564, '*Amendment to period of Summer Capacity Auctions to Six Months*'. This proposal, which was granted urgent status by Ofgem on 5 July 2002, provides for two separate 6 monthly MSEC allocations for the gas year 2002/03. Under the proposal, the auction for capacity for the period October 2002 to March 2003 would be held in summer

⁴ Modification proposal 0444, '*Extend Capacity Period Sold to 12 months in MSEC and MISEC auctions for February 2001*'.

2002 and the auction for the period April 2003 to September 2003 would be held in February 2003. Ofgem is expected to issue a decision on this proposal on 19 July 2002.

Capacity volumes

Prior to the September 2001 capacity auctions, MSEC volumes were determined on the basis of the SND methodology. This methodology uses historic terminal gas flow data to determine the amount of capacity to be made available at each terminal and does not take account of new gas market developments such as new fields, reduced profiles of existing fields, or changes to gas sales contracts. The use of the methodology raised concerns that the amount of capacity being released may be too low relative to the physical capabilities of the NTS. The methodology also was perceived to lack transparency and to provide Transco with a degree of discretion in determining the volumes of capacity to be made available.

While originally intended as an interim measure only, the methodology has been used to determine capacity volumes for all of the MSEC auctions held prior to September 2001.

In August 2001, Ofgem accepted Modification Proposal 0481, '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*'. This proposal was raised following concerns expressed by shippers regarding the volumes of capacity to be offered for sale in MSEC auctions for October 2001 to March 2002. This modification provided for a capacity release based on a proportion of maximum physical capacity levels.

Looking ahead, in the event that Ofgem's proposed modifications to Transco's GT licence relating to Transco's price control and SO incentives are implemented in the form consulted upon, Transco would be required to offer for sale 90 per cent of a set of baseline entry capacity output measures (the 'SO baseline volumes') through a series of auctions of longer and shorter-term firm, tradable capacity rights. Under the proposed licence modifications the NTS Transmission Asset Owner (TO) control baseline entry capacity outputs have been set at the maximum physical capacity levels for each entry point to the NTS. The SO baseline volumes of capacity were made available to shippers in the February 2002 MSEC auctions for the period 1 April 2002 to 30 September 2002 and were published in Transco's Transportation Statement.

MISEC allocation

The MISEC product was introduced in November 2000 following Ofgem's acceptance of Modification Proposal 0410, '*Auction of Monthly Interruptible System Entry Capacity*'. This modification provided for the release of entry capacity at maximum physical levels through a combination of MSEC and MISEC. The MISEC product was not offered in the February 2002 auctions following Ofgem's acceptance of modification proposal 0499 which provided for the release of firm capacity at close to maximum physical levels.

The initial proposal

Modification proposal 0549 provides for a number of changes to be made to the current auction arrangements relating to the capacity period 1 October 2002 to 30 September 2003.

Completion date

It was proposed that the latest permissible completion date of the allocation process be moved from 31 August to 31 July 2002.

Applicable period of capacity allocation

Transco sought views on whether the period of allocation should be amended and in particular, increased from 12 to 24 months.

Capacity volumes

The proposal provides for 100 per cent of the SO baseline volumes to be made available for the period 1 October 2002 to 30 September 2003. If 24 months of capacity was offered for sale, 80 per cent of the SO baseline volumes would be offered for sale for the 12 month period from 1 October 2003.

Number of auction rounds

The auction would be conducted over four rounds, with 25 per cent of available capacity offered in each round. Any capacity unsold in rounds 1 to 3 would be carried over to round 4. The proposal therefore suggests the removal of the round 5 allocation mechanism that is currently contained in the Network Code.

Later application for MSEC

The proposal also provides for the discontinuation of the MSEC allocation process for the release of unsold MSEC (the 'off-the-shelf' MSEC product). Transco stated that it anticipated that, if approved, Modification Proposal 0500 would introduce a rolling MSEC allocation that is intended to replace the present off-the-shelf product. Transco also outlined its view that the continuation of the release of the off-the-shelf capacity product could create difficulties in migrating to the proposed rolling MSEC allocation process.

MISEC

The provisions for the sale of MISEC would be discontinued given the proposed release of the SO baseline volumes.

Respondents' views

Completion date

A small majority of respondents supported retention of 31 August as the latest permissible completion date for the auctions. A number of these respondents argued that a later commencement is more appropriate given uncertainties associated with the outcomes of the long-term allocation proposals and the proposed modifications to Transco's GT licence. One respondent explained that there would be insufficient time between the decision on the modification proposal, the publication of the invitation to tender and the commencement of the auctions in July 2002.

Reasons cited by respondents arguing for a completion in July 2002 included that this would provide industry participants with additional time to focus on long term allocations and would also provide Transco with time to develop systems for the long-term allocation process. One respondent stated that completion of the auctions in July would allow Transco time to implement a rolling MSEC product. Further, two of the respondents supporting completion by 31 July stated that there must be at least two weeks between Ofgem's decision and the auction.

One respondent, while expressing no preference between a July or August auction, preferred that the long-term auctions not be held in the month following the short-term auctions. It

argued that at least two months was needed to obtain management approval for bidding strategies for the long-term auctions.

Applicable period of capacity allocation

Of the 18 respondents who commented on this issue, only two offered some support for the introduction of a 24-month capacity allocation. One of these respondents made their support conditional on the release of 100 per cent of the SO baseline levels in all months. A number of other respondents stated that all of the available capacity should be offered in any primary auction and therefore the auction should cover a period of no greater than 12 months thereby removing the need for Transco to withhold entry capacity for the gas year 2003/04. In this context, some respondents indicated that this would avoid both any inflationary impacts and the complexities and uncertainties associated with the holding back entry capacity in the second year of a 24 month allocation period.

While a majority of respondents offered some support for a twelve-month allocation period, a number of respondents expressed a preference for a six-month allocation.

Arguments for a 12-month allocation included that it would align the allocation with the gas year. A number of respondents were not in favour of moving to a 24-month allocation before the long-term auction arrangements and the proposed modifications to the price control and SO incentives provisions of Transco's GT licence are finalised and while there is uncertainty in the regime, particularly relating to the capacity neutrality arrangements. One respondent commented that the RGTA capacity system was slow and that it would be better to wait for the new long-term auction regime and systems to be in place before Transco starts selling capacity for more than 12 months in advance. Another respondent stated that a 12 month auction would balance the need for sufficient time to develop the long term auctions whilst minimising risks to shippers caused by uncertainties within the existing regime. One respondent indicated that a 12 month auction would allow the industry to gain experience of an auction of annual duration and maintain time horizons which provide shippers and Transco with more certainty of both their requirements and the provision of capacity.

A number of respondents favoured a continuation of six-monthly auctions. These respondents cited reasons that included the uncertainty surrounding the over-recovery redistribution mechanism, the treatment of buy-back costs and the need to finalise Transco's GT licence and associated documents. One of these respondents stated that, if 12 months of capacity are auctioned, no changes to pricing or neutrality arrangements which would affect shippers' valuations of capacity, should be implemented before 1 October 2003. Another respondent indicated that a six-month auction would be valuable in enabling shippers to understand how cash flows will operate under the new licence regime.

Capacity volumes

A clear majority of respondents supported the release of volumes of capacity related to maximum physical quantities, with most explicitly referring to the SO baseline volumes.

Number of auction rounds

All of the respondents commenting on this issue offered support for the proposal to implement four rounds of bidding, with any unsold being added to the quantity offered in the fourth round.

Later application for MSEC

A majority of the respondents commenting on this aspect of the proposal offered some support for the removal of the off-the-shelf capacity release.

However a number of respondents supported the removal of the off –the- shelf service on the basis that a rolling auction of unsold MSEC is introduced.

One respondent stated that some facility must exist to enable shippers to acquire unsold MSEC ahead of the next annual auction round. This respondent said that rolling MSEC auctions would allow for unsold MSEC to be sold closer to the start of the month of flow when the best information is available regarding capacity availability and users requirements.

On the other hand, one respondent opposed the removal of the off-the-shelf product on the basis that under the rolling MSEC auctions, shippers would only be able to access unsold capacity five business days before the month in which the capacity is required, whereas the off-the-shelf product is currently available following the completion of the auctions. Another respondent stated that shippers should be given certainty as to the mechanism for allocating unsold capacity and that this proposal should incorporate a rolling MSEC allocation. One respondent indicated that no decision should be taken on the removal of the off -the- shelf product until the long-term auction details have been resolved.

MISEC

The vast majority of respondents commenting on this aspect of the proposal supported the discontinuation of the MISEC product, with most noting that with a capacity release based on a proportion of maximum physical capacity the need for a MISEC release was diminished. One respondent also stated that interruptible capacity undermines the development of secondary trading and the value of the firm product.

However, another respondent offered support for the continuation of a MISEC release, stating that the product gave shippers an additional means of accessing entry capacity that did not incur buy-back costs and which guarded against hoarding.

Other issues

A number of respondents expressed concern that there are considerable uncertainties regarding the recovery of buy-back costs and the treatment of auction over-recoveries.

On a separate matter, one respondent argued that Transco should be providing information on its 2003 summer maintenance program prior to a 12 month auction. Another respondent indicated that this will be first time in which shippers will be bidding for capacity without knowledge of the maintenance programmes for the summer period where the capacity is being sold.

Transco's view and revised proposal

Completion date

While Transco considered it possible to have a decision on this proposal by the end of June, leaving two weeks before the auction, it recognised the concerns expressed by respondents with respect to the proposed modifications to its licence conditions and associated documents and the need for participants to understand the new regime before committing to an allocation process. Transco therefore proposes no change to the present timeline set out in the Network Code for the completion of the auctions (i.e. before 31 August 2002). Transco indicated that it anticipates conducting the auction between 1 and 14 August 2002.

Applicable period of capacity allocation

Transco recognises respondents' concerns with committing to 24 months of capacity and proposes a 12-month allocation.

Capacity volumes

Transco states that the modification proposal primarily seeks to align the quantities of system entry capacity with the SO baseline quantities that have been included in the proposed amendments to Transco's GT licence were these amendments to be implemented. Transco has indicated that if it is directed to implement this proposal all the quantities will be identified in Transco's Transportation Statement

Number of auction rounds

Transco's proposal to conduct the auction over four rounds, with 25 per cent of available capacity offered in each round and any capacity unsold in rounds 1 to 3 carried over to round 4, is unchanged.

Later application for MSEC

In a revised final modification report, reissued on 5 July 2002, Transco has withdrawn its proposal to discontinue the off-the-shelf product, considering that this aspect of the proposal is best considered as part of Modification Proposal 500. It stated that shippers would then receive a firmer assurance that a replacement capacity release process would be implemented if the off-the-shelf product were removed.

MISEC

Transco's proposal to discontinue MISEC is unchanged. It believes that MISEC was introduced to overcome concerns with the SND-based methodology for determining auction quantities and that replacement of the SND methodology with the SO baseline capacities removes this concern.

Ofgem's view

In assessing this proposal, Ofgem has restricted its comments to only those matters in respect of which Transco has sought to amend the Network Code. As such, Ofgem has not provided any views on those elements of the proposal that Transco has withdrawn, including the completion date proposal and the proposal to remove the off-the-shelf capacity product. Further, Ofgem has not provided any views on the length of the period over which capacity is to be allocated. This is because Transco has not chosen to amend the network code in this respect.

Capacity volumes

Ofgem welcomes Transco's proposal to offer for sale in the 12 month period from 1 October 2002 the SO baseline volumes of capacity. As we outlined in our decision on modification proposal 0499, this approach to the release of the SO baseline volumes ensures a transparent release of capacity at levels close to physical capabilities and removes the possibility that the historically based SND methodology could artificially restrict the amount of capacity being released to market. In particular, a release that is based on a proportion of maximum physical capacity levels will also ensure that the prices of entry capacity at

different terminals reflect actual demand and supply at different locations and are not the result of any artificial scarcity or perceptions of artificial scarcity created by the SND mechanism.

However, while Ofgem has proposed changes to Transco's GT licence which will (if implemented) specify the SO baseline outputs and require Transco to offer for sale these levels of capacity, Ofgem does not accept the proposition put forward by Transco in its final Modification report that this modification proposal would better facilitate the efficient discharge of its licence obligations when the licence obligations that Transco are referring to have not been implemented.

Number of auction rounds

As we stated in our decision on Modification proposal 499, Ofgem accepts that the rationale for the fifth round in the capacity auctions no longer applies. It was designed to optimise the amount of capacity that Transco made available and provide shippers with a degree of flexibility in determining the allocation of capacity amongst terminals. In particular, it enabled capacity at the margin to be allocated to the terminal where it had the highest value and ensured that any unsold capacity was made available to the market.

As part of this modification proposal, Transco will be offering for sale the SO baseline volumes at levels close to maximum physical capacity, which allows allocation between terminals to be optimised through a combination of the primary allocation and secondary markets, including capacity buy-backs. Transco will continue to offer capacity unsold in the first three auction rounds in the fourth round. This is consistent with the rationale underlying Ofgem's decision on modification 0499.

MISEC

Ofgem agrees that the continued use of the MISEC product is no longer warranted because the rationale underlying the introduction of the product no longer applies. The MISEC product was introduced to ensure a release of capacity at maximum physical levels through a combined release of firm and interruptible capacity products. However, this modification proposal will implement the release of a volume of capacity equal to the SO baseline capacity measures, which will ensure a release of firm capacity at close to maximum physical levels.

Other issues

Ofgem notes the views expressed by some respondents that the future arrangements for the recovery of Transco's buy-back costs and treatment of any auction over/under recoveries are uncertain. In this respect, Ofgem notes that Transco has recently raised Network Code modification proposal 559, '*Changes to Buy Back Liabilities*'. In summary, this proposal provides for a change in the methodology by which buy-back costs are distributed amongst shippers and is currently being consulted upon. Furthermore, Ofgem would also note that any auction over recoveries of revenue against Transco's target allowed revenue for the capacity auctions are currently addressed under the pricing methodology established through PC 65, '*Alternative method of funding entry capacity constraint management*'. Any change to these arrangements would need to be initiated by Transco through a pricing consultation proposal and would need to be consistent with the relevant charging methodology objectives as specified in amended standard condition 4A of Transco's GT licence.

Ofgem also notes the views expressed by respondents that Transco should be providing information on its 2003 maintenance program prior to the auction. In this respect Aep Energy Services Ltd has recently raised Network Code modification proposal 560, '*Publication of indicative maintenance schedule*'. Ofgem expects to issue a decision on this proposal shortly.

Ofgem's decision

Ofgem has carefully considered the issues raised by this modification proposal in relation to the forthcoming auction of entry capacity.

Ofgem considers that the proposal for Transco to offer for sale levels of capacity for the 12-month period from 1 October 2002 consistent with the SO baseline capacity volumes will better facilitate the efficient and economic operation by Transco of its pipeline system when compared with a release of capacity that is based on current levels of 110 per cent of SND levels. In particular, the release of the SO baseline volumes which have been set at a high proportion of maximum physical capacity levels should allow for the identification of the true location of any system constraints.

Ofgem also considers that the proposal will ensure that the prices of entry capacity at different terminals reflect actual demand and supply at different locations, thereby better facilitating the securing of effective competition between relevant shippers and between relevant suppliers.

In addition, Ofgem considers that the removal of the fifth round and the MISEC product will better facilitate the efficient and economic operation by Transco of its pipeline system, because these services are no longer required under a capacity release methodology that is based on maximum physical levels.

Accordingly, Ofgem has decided to direct Transco to implement this modification, as we consider that it would better facilitate the relevant objectives as outlined in Amended Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements