

OFGEM DECISION LETTER No. 0530
"Volume based test for Summer 2002 Entry Capacity"
Version 1.0



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Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0530: Volume based test for summer 2002 entry capacity

Ofgem has considered the issues raised in Modification Proposal 0530 ' *Volume based test for summer 2002 entry capacity*'. Ofgem has decided to direct Transco not to implement the modification because we believe that this proposal does not better facilitate the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

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 firm entry capacity 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 and February 2001, with the most recent completed in September 2001.

In addition to conducting MSEC auctions, Transco also conducted Monthly Interruptible System Entry Capacity (MISEC) auctions, which were introduced in November 2000 following Ofgem's acceptance of Modification Proposal 410, '*Auction of Monthly Interruptible System Entry Capacity*'. Further MISEC auctions have been held along with the MSEC auctions. The MISEC product has now been withdrawn following Ofgem's acceptance of Modification Proposal 499, '*Transition Arrangements for Long Term Capacity Allocation*'.

Transco also releases firm capacity on a daily basis. A within-day capacity market has operated since June 2000. Notwithstanding the removal of the MISEC product, Transco will continue to offer 'use-it-or-lose-it' (UIOLI) daily interruptible capacity, which is an anti-hoarding product.

Transco's Price Control (2002-2007)

Ofgem has recently completed its review of Transco's Price Control for the period 2002-2007 *Review of Transco's Price Control from 2002 Final proposals*, September 2001. and issued final proposals on Transco's NTS System Operator (SO) incentives for the same period. *Transco's National Transmission System - system operator incentives 2002-7 Final proposals*, December 2001.

The SO incentives final proposals are intended to provide financial incentives on Transco to invest in NTS entry and exit capacity where it is efficient to do so in response to its customers' changing needs. The proposals are also intended to improve the incentives on Transco to carry out its day-to-day role of operating the NTS economically and efficiently.

In relation to entry capacity, Ofgem has proposed that Transco be required to offer for sale 90 per cent of a series of baseline entry capacity output measures (as defined under Transco's TO price control) through a series of auctions of longer and shorter term firm, tradeable capacity rights. The NTS TO control baseline entry capacity outputs have been set at the maximum physical capacity at each entry point to the NTS.

Prices emerging from these auctions and subsequent trading of capacity will improve the signals to Transco of the need for additional investment in new capacity and under the proposed entry capacity incentive, Transco will have an incentive to respond to such signals.

Transco indicated its acceptance in principle of Ofgem's final SO incentive proposals on 31 January 2002 and Ofgem is proposing modifications to Transco's Gas Transporters (GT) Licence to specify the volumes of capacity that Transco will be required to offer for sale via an auction process for the period April 2002 to April 2007. Ofgem also intends to consult on changes to Transco's GT Licence to specify Transco's entry capacity and other incentives.

In relation to auctions of entry capacity, two Network Code Modification Proposals have been raised (Modification Proposal 0500, '*Long Term Capacity Allocation*' and 0508, '*A method of long term capacity allocation*'). These modification proposals are discussed in Appendix 2 of Ofgem's Final Transco SO incentive proposals document and are currently the subject of workstream and Network Code consultation processes.

February 2002 entry capacity auctions

On 6 February 2002, Ofgem wrote to the industry Letter to Transco, Shippers and Other interested parties, '*Summer 2002 Transco National Transmission System (NTS) Entry Capacity Auctions*', Nick Fincham, 6 February 2002. in order to set out the arrangements for the February 2002 auctions, following Ofgem decisions on three modification proposals (Modification proposal 499, '*Transitional Arrangements for Long Term Capacity Allocation*', 507, '*Abolition of Entry Capacity Reserve Price*' and 522, '*Deferral of Maintenance Publication Obligation*'). In particular, the letter sought to provide shippers with clarity as to the nature of the auction over and under-recovery mechanism and the energy and capacity neutrality arrangements for the 6 months commencing 1 April 2002 and ending on 30 September 2002.

In that letter, Ofgem confirmed that it would not propose modifications to Transco's GT Licence that would have the effect of discontinuing the existing capacity (and energy) neutrality arrangements for the six-month period commencing 1 April 2002. As such, and in the absence of any changes to the Network Code, the existing entry capacity (and energy) neutrality arrangements will continue in operation for a six-month period commencing 1 April 2002.

In terms of the treatment of auction over-recoveries between 1 April 2002 and 30 September 2002, Ofgem also noted that in the absence of any changes to Transco's existing charging methodology, the buy-back fund mechanism used to address any over-recoveries would remain in place. This methodology was

implemented under Pricing Consultation (PC) 65, *'Alternative Method of Funding Entry Capacity Constraint Management'* and revised via Pricing Consultation 67, *'Technical Adjustment to PC 65 Mechanism'*.

In the event of an under-recovery of auction revenue against allowed entry revenue, the buy-back fund will be set to zero in each month. Currently the established methodology with respect to adjusting under-recoveries is set out in Pricing Consultation 66, *'Transportation Charge Adjustments Following Entry Capacity Auctions'*.

As explained in our letter, any change to these arrangements would need to be initiated by Transco through the raising of a pricing consultation proposal, in a manner that complies with Transco's relevant methodology objectives as specified in Standard Condition 4A of Transco's GT Licence. For example, the development of mechanisms to address any residual over-recovery left over at the end of the 6 month period would need to be undertaken through changes to Transco's pricing methodology.

On 19 December 2001 Ofgem approved a delay to the auction timetable proposed in Modification Proposal 0505 *'Delay to January 2002 MSEC Allocation'*. On 31 January 2002 Ofgem approved Modification Proposal 499, *'Transitional Arrangements for Long Term Capacity Allocation'*. It rejected both Modification Proposal 507, *'Abolition of Entry Capacity Reserve Price'* and 522, *'Deferral of Maintenance Publication Obligation'*.

Following these decisions, on 2 February 2002, Transco issued an invitation to participate in the auction. Consistent with that invitation, the auction will have the following features:

- It will commence on 15 February 2002.
- Transco will offer volumes of MSEC consistent with Ofgem's final SO proposals.
- The auction will consist of 4 pay-as-bid auction rounds of 25 per cent each, with any unsold capacity from the first three rounds being carried over to the fourth round. The fifth round will no longer be conducted.
- MISEC will no longer be offered for sale.
- Any unsold MSEC will remain available for sale prior to the day as an 'off-the-shelf' product.
- The auction will be for 6 months and capacity will be offered for sale in all months between April and September 2002.
- Monthly reserve prices will apply at all terminals.

In addition, on 31 January 2002, Transco published its draft maintenance programme for the 24 month planning period commencing 1 April 2002.

The Modification proposal

This modification proposal seeks to include a single volume based round prior to the commencement of the forthcoming summer 2002 Monthly System Entry Capacity (MSEC) auction to determine whether shippers' entry requirements are within the baseline capacity volumes that are to be offered. Specifically, the modification proposes that:

a preliminary round is included immediately prior to the start of the pay-as-bid auction;
shippers will submit their volume requirements to Transco per ASEP, per month;
where this capacity requirement is less than the published baseline volumes, Transco will sell capacity to match shippers' requirements at the relevant reserve price and the further rounds of the auction process will not be held;
where shippers' capacity requirements exceed baseline volumes, the auction process will continue for all ASEPs for the months in which the baseline capacity is exceeded.

The modification proposal seeks to determine whether there is likely to be any over-recovery following the auction and seeks to remove auction rounds where they are not necessary.

The modification proposal was submitted to Ofgem for urgency on 31 January 2002. Ofgem agreed that the modification proposal merited urgent status given the next series of entry capacity auctions are currently due to commence on 15 February 2002.

Respondents' views

Respondents' views on this proposal were fairly evenly divided, with a slight majority supporting the proposal.

A number of respondents supported the stated purpose of the proposal to provide clarity to Users as to the product being offered for sale, by establishing whether there is likely to be an over-recovery and to eliminate that over-recovery where demand for capacity is below the baseline quantities. One such respondent argued that the proposal would provide an incentive on shippers to not demand quantities in excess of their requirements, because that may have the effect of leading to an auction process in which resulting prices would be higher than the reserve price. Some of these respondents argued that this would reduce the risk of the 'subsequent discriminatory redistribution' of such amounts.

One respondent, while giving qualified support for the proposal, said that it was difficult to predict the outcome in terms of the level of revenue recovery. While this respondent agreed that a volume-based allocation at reserve prices would reduce the likelihood of an over-recovery at certain terminals, it noted that this would be the first summer in which Transco would be offering for sale the baseline quantities and it would be difficult to predict the outcome. It said that, regardless of the allocation mechanism, the exact degree of under/over-recovery would always be unknown until the end of the capacity period.

A number of respondents also supported the justification made for the proposal on the basis of uncertainties surrounding the details of the auction regime. However, in this respect, one respondent, while offering qualified support for the proposal, welcomed Ofgem's letter of 6 February 2002, which provided assurance that Ofgem would not be proposing modifications to Transco's GT Licence that would alter the current buy-back and over/under recovery mechanisms for the capacity regime from April to September 2002.

One respondent supported the proposal on the basis that there should be no differences in prices paid by any shipper for entry at the same entry terminal and that this would result if the aggregate demand was less than the baseline.

Another argument made in support of the proposal was that it would reduce the administrative burden of allocating capacity at those terminals where there is adequate summer capacity. In this respect several respondents commented that the proposal would improve the efficiency of the auction process.

Another respondent believed that it is likely that the increase in the amounts of capacity released, consistent with the SO final proposals, would result in demand being less than that offered at the majority of ASEPs over many months and argued that it was sensible to avoid unnecessary auction rounds.

However, another respondent qualified its support for the proposal because it did not agree with the way it required all ASEPs to be determined under 'pay—as-bid' in the event that there was excess demand at one ASEP. This respondent argued that in this situation, where volumes at a particular ASEP for a particular month were below the baseline quantities, then this demand should be allocated at the reserve price, rather than requiring all ASEPs in a month to go into a subsequent pay-as-bid auction.

While supporting the proposal, one respondent recognised the potential for 'wrecking' bids to force an auction process. This respondent and another respondent argued that Transco should publish aggregate

demand at each ASEP for all months, including those that did not clear, in order to help minimise the consequences of such actions. One of these respondents argued that this would avoid over-reaction in the market.

However, another respondent, while offering qualified support for the proposal, argued that publication of this data could 'spook' the price auction and raise prices.

One respondent stated that despite the tight timescales associated with the proposal its implementation was nevertheless achievable and would involve only minor system changes for Transco.

Another respondent, while giving qualified support for the proposal, felt that the short consultation time had not allowed enough time for consideration of all of the implications of the proposal. In addition, it argued that shippers needed a minimum of two business days between the 'test' and the start of any subsequent price auctions, which suggested that the latest start date the 'test' could happen would be 12 February.

A number of respondents did not support this proposal.

One respondent argued that the proposal was unlikely to have a major impact on the process this year and it did not believe that it would reduce the over-recovery, most of which has been achieved at a single ASEP in recent auctions. This respondent argued that given the feature of the proposal that if a single ASEP were oversubscribed, no ASEPs for that month would close out in the initial round, it was likely that few, if any months would close out from this preliminary round.

One respondent argued that there was the potential for competition between shippers to be distorted because the quantities at which shippers would bid for at reserve prices would not be consistent with those in a 'pay-as-bid' auction.

One of these respondents further argued that the proposal would exaggerate demand levels and exacerbate future buy-back requirements through non-physical players seeking to acquire capacity and would be more likely to result in an even greater over-recovery. It suggested that, if the proposal is implemented, there should be an additional charge imposed on unused entry capacity, over and above any charging back of buy-back costs. It argued that this would reduce the potential for hoarding, given the dangers of releasing additional UIOLI capacity.

A number of respondents felt that the proposal may result in increased prices for those ASEPs in which the proposed initial round showed a level of demand in excess of the quantities offered by creating an impression of a shortage of capacity.

A number of respondents opposed to the proposal, while recognising that there was considerable uncertainty about the future treatment of over/under recoveries and buy-backs, argued that Ofgem had now clarified the regime. One of these respondents further argued that implementation of the proposal would require manual work rounds which would create significant risks. It preferred to keep changes to the auction rules and format to a minimum and retain the framework and timetable set out in Transco's invitation to tender.

Some respondents did not see any justification for the proposal, but rather felt that it imposed additional risks to auction participants. In particular, a number of respondents argued that the proposal may cause Transco to under-recover, given that reserve prices are set at 75 per cent of LRMC.

One respondent argued that the possible allocation of some months of capacity in the proposed auction round may mean that there is no flexibility to adjust volume requirements at the particular ASEP(s) over the six-month period in the event that shippers wish to avoid higher priced months. This respondent also argued that there are only a few shippers that have the flexibility to 'move' gas to different terminals and

therefore the proposed allocation under the existing auction mechanism for all ASEPs in a particular month would do little to alleviate the problem.

One respondent argued that the proposal would not reduce the uncertainty that shippers face as to over or under-recoveries, but would further complicate the process at short notice. In this respect, a number of other respondents argued that it was very important to avoid late changes to the auction process. One respondent argued that the timing of the proposal did not allow enough time for the industry to accurately assess the impact of the proposal. In addition, this respondent understood that the proposal would involve a manual process, which would impose 'unacceptably short lead times' prior to the pay-as-bid auction process.

Transco's views

Transco, while believing that there would be merit in further discussion of the proposal, does not support implementation of the proposal at this time.

Transco noted that any outcome arising should the proposal be implemented would be possible under the current arrangements. Transco therefore state that if this proposal were to lead to an efficient outcome then such an outcome is not precluded by the current auction process. In relation to the efficiency of the auction process, Transco recognised that the proposal may have benefits for those months where the current auction process would not need to be held. However, it believed that any such benefits may be offset by the additional risk arising from the 'significant and complex manual work rounds' and processes required. Transco argued that this was particularly so given the short timescales proposed.

Transco considers that, given the differing views expressed there would be merit in further discussion of the proposal. However, Transco states that the present auction timetable does not allow sufficient time for this to be achieved.

Ofgem's views

Whilst Ofgem recognises the issues raised by the proposer regarding the nature of the capacity product being offered for sale, Ofgem nevertheless considers that many of the uncertainties raised by shippers in their responses have now been resolved. In addition, Ofgem has a number of particular concerns regarding the merits of this proposal. These are outlined below.

Firstly Ofgem believes that this proposal may, if implemented, restrict the ability of bidders to switch between particular months in determining their capacity requirements during the MSEC auctions. In this respect, Ofgem considers that any allocation of capacity in a particular month (eg April) during the preliminary round may prevent bidders from shifting their demand for capacity to that month in a later pay-as-bid round in response to high price signals exhibited at an ASEP for a different month (eg May). Ofgem does not believe that this would better facilitate an efficient allocation of capacity and therefore the securing of effective competition between shippers.

Further, whilst the proposal may be capable of reducing the administrative costs of the auction process, Ofgem does not believe that such an outcome is guaranteed. Indeed, it may act to increase administrative costs in the event that there is excess demand revealed at particular terminals in any month. In particular, Ofgem believes that there exists a possibility that some bidders may seek to 'game' the preliminary round in order to progress the auctions to the pay-as-bid rounds. This may mislead other bidders as to the true value of capacity.

Ofgem recognises that some respondents have expressed a desire to reduce the likelihood of an over-recovery of allowed revenues in the forthcoming auction. However, Ofgem agrees with those respondents who questioned whether the proposal would lead to this result. In this respect, Ofgem notes that the existing 'pay-as-bid' auction process is capable of avoiding an over-recovery at unconstrained

terminals. As such, Ofgem would question whether the addition of the preliminary round provides any significant benefits.

Ofgem also acknowledges that Transco and one respondent has expressed concerns about the manual processes that would be required in order to implement the proposal and recognises that these processes may create additional risks of errors emerging.

Ofgem is mindful of the views expressed by some respondents against making last minute changes to the allocation process. In this respect we would repeat the concerns we raised prior to the September 2001 auctions regarding the timing of modification proposals and their proximity to the auctions. We would therefore encourage shippers in future to ensure that proposed amendments to the Network Code are conducted well before the auctions are due to start.

Ofgem's decision

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

For the reasons outlined above, Ofgem does not believe that this proposal better facilitates the securing of effective competition between relevant shippers and between relevant suppliers. Further, given the process concerns raised by Transco, Ofgem does not believe that this proposal will better facilitate the efficient and economic operation of the NTS.

Accordingly, Ofgem had decided to not consent to this modification, because we do not believe that it will better facilitate the achievement of the relevant objectives as outlined in Standard Condition 9 of Transco's GT Licence.

If you have any questions with regard to any of the issues outlined in this letter, please feel free to contact me on the above number.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements