

**Modification Report**  
**Abolition of Entry Capacity Reserve Price**  
**Modification Reference Number 0507**  
Version 3.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

**1. The Modification Proposal**

Norsk Hydro (UK) Limited proposes that reserve prices are removed for entry points where historically competition exists which should be determined by an excess of five active bidders.

**2. Transco's Opinion**

Since the introduction of entry capacity auctions, consistent with its licence obligations Transco has supported the use of reserve prices at all terminals. Transco believes that reserve prices can play an important role in minimising the ability of any players abusing market power. In setting reserve prices Transco has sought to avoid distortions to the auction process and bidders valuations, thereby promoting efficiency while avoiding undue preference in the supply of transportation services. Transco is not therefore in support of the modification proposal.

Transco is particularly concerned by the proposer's suggested definition of "competition" at entry points. Although the number of bidders is a guide to the level of competition, there may well be one dominant player at an entry point capable of exercising market power. Transco believes a better measure would be the use of concentration ratio or the Herfindahl-Hirschman index, as described in Transco's Pricing Consultation Paper (PC48 - "Methodology for determining floor prices for auctions of monthly entry capacity"). Both of these measures suggest that all entry capacity auctions to date have been highly concentrated.

Transco observes that the proposal does not specify whether the removal of reserve prices is intended to apply to short term capacity auctions or long term capacity auctions, subject to the final business rules for the capacity auction in the new price control period (i.e. 1 April 2002 onwards). The removal of reserve prices could create different outcomes depending on the type of auction. In short term auctions, if the recoverable revenue falls below the allowable revenue, then this raises issues of how the shortfall is recovered through adjustments to other charges. However, under Ofgem's final proposals for the SO incentive mechanism, if the value of bids received in long term auctions is below the cost of providing additional capacity, then Transco may not be appropriately incentivised to invest in additional capacity. This may be a concern if the application of zero reserve price leads to Shippers offering bids which do not reflect their valuation of capacity.

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

The Proposer is of the opinion that the Modification Proposal would better facilitate the relevant objectives by reducing the discriminatory effect that the revenue redistribution resulting from the auction process has on sectors of the UK Gas Market.

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

Transco does not anticipate any such implications.

**b) development and capital cost and operating cost implications:**

Transco does not anticipate any such costs.

**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:**

Transco anticipates that the implementation of this Modification Proposal would not lead to an increase in costs.

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

Any under-recovery that could arise as a result of implementation of the modification proposal would be met via an adjustment of other NTS charges. This may lead to increased instability in the level of charges.

**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 such consequences are envisaged.

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

If the modification proposal contemplates a reduction in the reserve prices to zero, no such implications are envisaged.

**7. The implications of implementing the Modification Proposal for Users**

At those entry points where competition exists, as defined by the Modification Proposal, Users bidding for entry capacity at those entry points will not be required to bid at prices greater than a reserve price.

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

There may be an impact on end-users' charges, depending on whether Shippers pass on any changes in transportation charges.

**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 envisaged.

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

Advantages :

Avoids possible distortion of bids for entry capacity

Retains measure to minimise possible abuse of market power

Disadvantages :

May increase likelihood of under-recovery and volatility in transportation charges

May weaken investment signals, thus discouraging Transco to invest in system reinforcement

Would leave uncertainty in respect of defining "competition" at entry points.

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

Representations have been received from the following eleven parties :

Association of Electricity Producers	AEP
AGIP (UK) Ltd	AGIP
BG Group	BG
British Gas Trading	BGT
ExxonMobil International Ltd	Exxon
Innogy	In
Marathan Oil UK Ltd	MO
Powergen	PG
Shell Gas Direct Ltd	SGD
Scottish and Southern Energy Ltd	SSE
Statoil (UK) Ltd	STUK

Of these, four respondents express support for the modification proposal while seven do not support the modification proposal.

General

Of those respondents expressing support for the proposal, STUK does so only on the basis that it forms part of the transitional arrangements for the next auction period and on the assumption that the next auction period will be of 6 rather than 12 months duration. It argues that the removal of reserve prices at ASEPs where there is deemed to be a sufficient level of competition will remove the artificial pricing floor which, in its view, is there predominantly for Transco's revenue protection rather than facilitating competition.

STUK and PG suggest that following previous levels of over-recovery it is unlikely that significant under-recovery for Transco will be an issue in the next auctions. STUK believes that the removal of floor prices would help mitigate the extent of distortions resulting from over-recoveries, a view also expressed by Marathan Oil. PG suggests that competitive bidding behaviour means that prices are always set above the reserve price.

In respect of those views put forward against the modification proposal, BG Group and SSE argue that the presence of reserve prices has not contributed to distortions or influenced the MSEC auction bid prices and levels of over-recovery. SSE and BGT consider that the primary reasons for over-recovery have more to do with the design of auctions, a perception of scarcity of capacity, and the level of overrun charges. SSE further argues that removing floor prices could lead to more distortions in bidding and scope for a larger price spread.

#### Levels of Under-recovery/Revenue Apportionment

Five respondents (AEP,BGT,BG,In,SSE) argue that a removal of reserve prices at competitive terminals would increase the likelihood of under-recovery at the forthcoming MSEC auctions. They suggest that this would be particularly likely at the next set of short term capacity auctions as the volumes available, based on winter peak levels, will be far in excess of what will be physically available during the summer months. SSE and AEP state that the level of under-recovery would be significant if the trend observed in the last set of auctions of falling prices in successive rounds were to be repeated. PG suggests otherwise, commenting that reserve prices can lead to over-recoveries which can be discriminatory, and create distortions in the market.

Four respondents (AEP,BG,In,SSE) also comment on the uncertainty in understanding the potential impact of any under-recovery on transportation charges. SSE states that its concerns are compounded by the lack of clarity in respect of how any under-recovery would be recouped under the new price control. AEP requests clarification of the revenue adjustment mechanism in the new formula, including an understanding of the adjustment period and the notice period given in the event of any changes to transportation charges.

Three respondents (SSE,In,AEP) make the assumption that any under-recovery would be addressed within changes to NTS charges only. Innogy suggests that this would redistribute revenues to the upstream from the downstream sectors of the gas chain. AEP suggests that any under-recovery is likely to be managed by increasing other NTS charges, thus creating instability and uncertainty in the level of transportation charges that consumers would face.

#### Definition of Competition

Four respondents (In,BGT,AEP,SSE) put forward the view that the proposed criteria to determine whether sufficient competition exists at an entry point is arbitrary and inappropriate. SSE and AEP suggest that the measure of five active bidders at a terminal would not guard against the possibility of one of the players having a dominant share of say, 80%, which could hardly be described as competitive. SSE considers that a more appropriate measure would be to consider the number of bidders and their market shares. AEP and BGT suggest the use of the "Herfindal-Hirschman" index as a much better gauge of competition.

#### Other Points

Three respondents (AGIP,Exxon,STUK) suggest a review of the issue of reserve prices in light of the chosen allocation method for long term entry capacity.

Innogy proposes that any reduction in capacity prices towards zero would lead to an overselling of entry capacity, thus increasing Transco's level of buy-back costs, shared by all MSEC holders.

SGD and STUK express the view that the removal of reserve prices may have to be affected by a change to Transco's Transportation Statement rather than a modification to the Network Code.

SGD also expresses concern that modifications are being raised which confuse what should be in the Network Code, such as Modification 0494 (Amendments to the Capacity Revenue Neutrality) and Modification 0510 (Provision of Additional gas Flow Information). It argues that the problem is exacerbated by the volume of work instituted to change the capacity regime, Transco's incentives and Transco's GT licence. SGD also comments on the apparent conflict between Transco's obligation to set charges to reflect costs or to reveal shipper's propensity to pay and request Ofgem and Transco to address this apparent conflict.

SSE suggests that at less competitive terminals, notably Barrow, there is merit in rebalancing the reserve price so that it is not a discounted LRMC charge, as shippers purchasing capacity at this entry point are receiving a significant discount for landing gas.

BGT comments that if the expected revenue level is not achieved by the proposed methodology Transco may not receive the incentive required to provide additional capacity at a specific Entry Point.

#### Transco's Response

##### General

In response to the comments put forward on the modification proposal, Transco's view on the importance of reserve prices remains unchanged. As stated in Section 2 of the Modification Report, Transco believes that reserve prices can play an important role in minimising the ability of any player to abuse market power. In setting reserve prices Transco has sought to avoid distortions to the auction process and bidders valuations, thereby promoting efficiency whilst avoiding undue preference in the supply of transportation services. This is consistent with Transco's GT licence obligations.

##### Levels of Under/Over-recovery and Revenue Apportionment

Transco would suggest that past auction results may not be an ideal guide to those in future periods given the increasing volumes of entry capacity that it is envisaged will be made available. Transco would also point out that in the most recent set of MSEC auctions (winter 2001 / 02) decreasing prices in successive rounds were observed, and the likelihood of significant under-recovery would still represent a risk.

Transco recognises that lack of certainty in the treatment of any under/over-recovery creates difficulties in assessing the likely future impacts of under or over-recovery scenarios. Such outcomes for short term capacity and long term capacity auctions are discussed within Section 2 of the Modification Report. However, Transco would point out that Ofgem's final proposals for SO incentives suggest that "Ofgem's view is that the use of system (charged on the basis of gas flows) should be used to adjust Transco's revenues in the event of any under or over-recovery resulting from the auctions."

### Definition of Competition

Transco agrees with the concerns expressed by respondents with regard to the definition of "competition" at entry points, which Transco has also articulated in Section 2 of this Final Modification Report

### Other Points

With regard to the issue of reserve prices for long term capacity auctions, Transco agrees that the issue is best debated within ongoing development of the business rules governing long term capacity auctions. Transco does not agree that the removal of floor prices would necessarily lead to over selling of entry capacity since the minimum volumes of capacity to be made available are expected to be set out in Transco's GT Licence, with no obligation to accept bids for capacity in excess of the specified baseline.

Transco believes that the reduction of reserve prices to zero would require a change to its Transportation Charging Methodology whereas the removal of reserve prices could be achieved via a Network Code modification.

In respect of any apparent conflict between Transco's obligations to set charges to reflect costs or to reveal shippers' willingness to pay, Transco would argue that the setting of reserve prices by the LRMC methodology is consistent with its licence obligations.

In respect of reserve prices at less competitive terminals, Transco would point out that terminals with an Herfandahl-Hirschmann Index greater than 8,000 are subject to a specific methodology aimed at minimising the potential benefits derived from market power at such terminals.

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

Transco is unaware of any such requirement

## **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**

Transco is unaware of any such requirement.

**14. Programme of works required as a consequence of implementing the Modification Proposal**

As implementation would not impact on UK Link systems, a program of works is not required.

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

Transco does not recommend implementation and therefore has not proposed an implementation timetable.

**16. Recommendation concerning the implementation of the Modification Proposal**

Transco recommends rejection of this Modification 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:

**Tim Davis**  
**Head of Regulation NT&T**

Date:

**Gas and Electricity Markets Authority Response:**

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0507**, version **3.0** dated **24/01/2002**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **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 (whether such approval is actual or deemed by effluxion of time) any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.
3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, had it not been repealed, would apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) or 2(2)(b)(ii) of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.
4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.