

19 December 2001

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/0505

Dear Colleague,

Modification Proposal 0505 'Delay to January 2002 MSEC Allocation'

Ofgem has carefully considered the issues raised in Modification Proposal 0505 '*Delay to January 2002 MSEC Allocation*'. Ofgem has decided to direct Transco to implement the modification because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code. As a result of this decision the commencement date for the next Monthly System Entry Capacity (MSEC) auctions will now be 12 February 2002.

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 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 of MSEC were held in March 2000, August 2000, February 2001 and September 2001, for the sale of six months of MSEC. The next MSEC auctions are due to be completed by 31 January 2002.

There are currently five rounds in the MSEC auctions and, following Ofgem's acceptance of Modification Proposal 0409, '*Review to Monthly Capacity Auction Parameters*', the period between auction rounds is two days. This two-day period is designed to assist shippers in assessing and/or refining their bidding strategies in the light of results of previous auction rounds in time for subsequent rounds. It is noted that the period between auction rounds was reduced from two days to one day for the most recent set of capacity auctions following Ofgem's acceptance of modification proposal 0482, '*Delay to System Entry Capacity Auction for the period 1 October 2001 to 31 March 2002*'.

In addition to conducting MSEC auctions, Transco also conducts Monthly Interruptible System Entry Capacity (MISEC) auctions. The first of these auctions was held in November 2000 for a period of four months (December 2000 to March 2001) and further auctions were held in March 2001 and September 2001. The next MISEC auctions are due to be completed by 15 February 2002.

Delays to entry capacity auctions

The entry capacity auctions have often been delayed when compared to the original timetable agreed for holding the auctions. These delays are largely attributable to proposals that have been raised to modify the capacity regime in the period immediately prior to the commencement of the auctions. Transco, shippers and customers have all expressed concern about repeated delays in the auction timetable and the additional uncertainty this can cause.

In addition, Ofgem has frequently made clear its concerns regarding the timing of proposals to change the capacity regime and the uncertainty that this can create. In this context, in a letter to Transco, shippers and other interested parties of 24 August 2001, Ofgem encouraged shippers to ensure that future proposals to amend the Network Code and Transco's pricing methodology are raised in a timely manner and well before auctions are due to start.

Regrettably however, during each series of auctions to date, modification proposals have been raised to address issues with the current arrangements close to the proposed auction date. In each instance, a balanced decision has had to be taken about whether to delay the auctions to allow shippers and other interested parties to understand the impact of any modifications prior to the commencement of bidding.

In this respect, the last set of entry capacity auctions was delayed following Ofgem's acceptance of Modification Proposal 0482, *'Delay to System Entry Capacity Auction for the period 1 October 2001 to 31 March 2002'*. This delay was necessitated by changes that were made to the volumes of entry capacity to be released in the auctions brought about by Modification Proposal 0481, *'Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction'*. Prior to Ofgem's acceptance of this proposal, the auctions for 1 October 2001 to 31 March 2002 had been scheduled for completion by 31 August 2001. However, following the acceptance of modification 0482, the completion date for the MSEC auctions was amended to 10 September 2001. The delay was necessary to allow the industry additional time to assess and familiarise themselves with the revisions made to the volumes of entry capacity released in the auctions.

In its decision Ofgem indicated that it is desirable for customers and industry for the auctions to be held well in advance of actual gas flows against acquired capacity holdings. This would allow participants time to consider bidding strategies with certainty over the rules of the auctions and would provide customers with greater certainty when contracting for gas. However, Ofgem indicated that in the circumstances it would not have been in the industry's or customer's interests to proceed with the auctions if the shippers had not had sufficient time to consider a material change to the regime. Ofgem reiterated its disappointment that Transco and/or shippers had not sought to address concerns about the auction arrangements that were in place at the time well before the auctions were due to commence.

Review of SO incentives and long-term auctions

Of gem has recently completed its review of Transco's Price Control for the period 2002-2007¹ and issued final proposals on Transco's NTS System Operator (SO) incentives for the same period.² Transco has until 31 January 2002 to accept the proposals contained in the December SO incentives document.

The SO incentives proposals are intended to provide financial incentives on Transco to invest in the NT5 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 NT5 economically and efficiently.

The proposed SO incentive framework will require Transco to offer minimum levels of entry capacity for sale through a series of long and short term auctions of firm, tradeable capacity rights. 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.

In order to implement these changes, a range of modifications to Transco's Gas Transporter's (GT) licence, the Network Code, and Transco's pricing methodology will be required. In relation to auctions of entry capacity, changes will be needed to Transco's GT licence to specify the output measures and the volumes of capacity that it is required to offer in auctions from 1 April 2002 to 31

¹ *Review of Transco's Price Control from 2002 Final proposals*, September 2001.

² *Transco's National Transmission System -system operator incentives 2002-7 Final proposals*, December 2001.

March 2007. Amendments to the licence will also be necessary to specify Transco's entry capacity incentive details. In addition, a number of changes will be required to the Network Code to introduce the details of the long-term entry capacity auctions.

Ofgem notes that a number of Network Code modification proposals relating to the entry capacity regime from 1 April 2002 onwards have already been raised.

One of these proposals, modification proposal 0499 '*Transition Arrangements for Long term capacity allocation*' provides for the implementation of transitional arrangements for the allocation of entry capacity, prior to the proposed introduction of long-term auctions. In particular, the proposal provides for amendments to the structure of the next series of monthly auctions, including an increase the period of capacity offered from 6 months to 12 months, provision for the volumes of capacity to be offered, a reduction in the number of auction rounds to four, the removal of the 'off the shelf' MSEC product and the removal of the MISEC product. The proposal also included a delay to the auctions, but this now forms the subject of modification proposal 0505.

In addition, two modification proposals have been raised concerning the allocation mechanism for long term entry capacity. These are modification proposals 0500, '*Long Term Capacity Allocation*' and modification proposal 0508, '*A method of long term capacity allocation*'. These proposals are currently being discussed in industry workstreams.

On 20 November 2001, Ofgem agreed that modification 0505 merited urgent status to provide shippers and Transco with certainty on the timing of the next series of MSEC auctions. In particular, Ofgem considered this certainty should assist Transco and shippers in both planning and prioritising work for the development of the entry capacity regime from April 2002.

The proposal

Modification proposal 0505 proposes to delay the next MSEC auctions by four weeks such that the allocation process would be completed by no later than 28 February 2002.

Respondents' views

A clear majority of respondents supported the proposal.

Of those respondents supporting the proposal several indicated that a delay was necessary in view of the uncertainties that exist surrounding the nature of the long term capacity regime and Transco's SO incentives.

One respondent indicated that a delay of one month was necessary to allow for shippers to assimilate additional information that becomes available regarding the nature of the regulatory regime as it develops. This shipper indicated that the delay allows better planning and prioritisation of the work being carried out by the industry on the short and long-term arrangements. Another respondent said the delay was necessary to enable shippers more time to assimilate the impact of a number of industry changes currently in development.

One respondent, whilst appreciating the concern that a delay would reduce the lead-time between the auctions and the start of the relevant capacity period, nevertheless felt that a delay was essential to enable shippers to bid in a considered manner for entry capacity. The shipper suggested that in the absence of a delay there may be insufficient time for the relevant regulatory details of the future capacity regime to be resolved. This respondent did not believe that reducing the lead-time prior to the start of the capacity period would be a significant issue because the auctions would be completed by the end of February.

Some respondents added that there should not be a further delay of the auctions beyond the proposed four weeks. However, one such respondent said that a further modification proposal could be raised if a further delay proved necessary as a consequence of complications arising out of the ongoing developments.

Another respondent felt that a delay should enable the industry to avoid the past experience of urgent modifications in the run-up to the auctions, thereby improving the stability and efficiency of the regime, in the interests of all parties, including customers.

One respondent felt that the current time allowed between auction rounds was insufficient and called for the period to be increased to four working days. This respondent said that if this could be achieved, it would necessitate a delay to the auctions.

Two respondents did not support the proposal. One of these respondents believed that the community has had sufficient time to discuss the new regime and to develop and implement changes to the capacity regime. The respondent indicated that delays would create uncertainty.

Another respondent felt that reducing the period between allocation of capacity and the start of the relevant capacity period was not in the best interests of customers. This respondent said that the proposed delay would mean that any changes to transportation charges resulting from the auctions would be made at less than the two months notice required by the Network Code. The respondent indicated that this would mean that customers and suppliers would not be able to accurately assess their transportation charges from April 2002 until only a few weeks before the first gas flow day.

In this context the respondent urged Transco to ensure that its proposals to amend the Network Code and its pricing methodology are brought forward as soon as possible to clarify the regime and charges from April 2002 for the benefit of customers and suppliers.

Transco's view

Transco believes that the proposed delay to the auctions is necessary to provide users with more time to understand the implications of changes that may arise from the periodic review of its transportation business.

Ofgem's view

Ofgem agrees with respondents that a delay to the capacity auctions is necessary to allow sufficient time for Transco, shippers and other industry participants to develop the framework for the allocation of entry capacity rights from April 2001 onwards. In reaching this decision Ofgem recognises that the implementation of entry capacity arrangements from April 2001 will require a significant number of changes to the regulatory framework including amongst other things Transco's GT licence, the Network Code, and Transco's pricing methodology. Many of these changes are the subject of modification proposal 0499 and will need to be finalised, along with any other short-term changes that are proposed, prior to the next series of capacity auctions.

In addition, Ofgem recognises that the details of Transco's incentive arrangements for the capacity period commencing 1 April 2002 may not be resolved until after 31 January 2002, the final date for Transco to accept Ofgem's SO incentive proposals.

In view of this, Ofgem believes that a delay is necessary to provide industry participants with sufficient time to develop the capacity arrangements from 1 April 2002 and to effectively prioritise work. A delay would also provide shippers with time to consider the changes in order to develop their bidding strategies in advance of the auctions.

Ofgem is aware of the concerns held, particularly by some customers, that any delay to the auctions creates uncertainty in negotiating gas supply contracts. Ofgem understands these concerns and continues to believe that, as a general principle, it is desirable for customers and the industry to hold the auctions well in advance of actual gas flows against acquired capacity holdings. Indeed Ofgem has previously made clear in recent letters and Network Code decisions that amendments to the existing capacity regime need to be made sufficiently early to allow them to be addressed well before the auctions are commenced.³ In this respect it is encouraging to note that modification proposals for the capacity period commencing 1 April 2002 have already been raised.

Nevertheless, Ofgem considers that in the case of this proposal, a failure to delay the next series of entry auctions could result in distortions due to a lack of sufficient time to consider the changes to the regime that will be developed in early 2002. In this context, a delay would better facilitate the securing of effective competition between shippers, ultimately to the benefit of customers.

Ofgem's decision

Ofgem believes that this proposal better facilitates the securing of effective competition between relevant shippers and between relevant suppliers by allowing participants in the forthcoming capacity auctions the time to assess any changes to the regime that are made in January 2002 in preparing their bidding strategies.

Accordingly, Ofgem has decided to consent to this modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 9 of Transco's GT licence. We therefore direct Transco to implement the proposal.

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

³ Modification 0482 '*Delay to System Entry Capacity Auction for the period 1 October 2007 to 31 March 2002*'. See also Ofgem letter to Transco, shippers and other interested parties of 24 August 2001 entitled '*Winter National Transmission System (NTS) Entry Capacity Auctions*'.