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Transco, Shippers and Other Interested Parties

9 August 2001

Our Ref: Net/Cod/Mod/O482

Dear Colleague,

Modification Proposal 0482 'Delay to System Entry Capacity Auction for the period 1st October 2001 to 31st March 2002'

Ofgem has carefully considered the issues raised in Modification Proposal 0482 *'Delay to System Entry Capacity Auction for the period 1st October 2001 to 31st March 2002'*. 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 set of System Entry Capacity Auctions will now be the 29th August 2001.

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 entry capacity to its National Transmission System ('NTS'). The auctions provided for the allocation of firm monthly system entry capacity (MSEC) to successful bidders for a total period of six months from 1 October 1999 to 31 March 2000. Further series of auctions were held in March 2000, August 2000 and February 2001.

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.

In addition to conducting MSEC auctions, Transco conducts monthly interruptible system entry capacity (MISEC) auctions. The first of these auctions was held in November 2000 for a period of four months from December 2000 to March 2001 and a further set of auctions was conducted in March 2001 for the six-month period April to October 2001.

To date, each series of auctions has been the subject of delays 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. Ofgem, Transco, shippers and customers have all expressed concern about repeated delays in the auction timetable and the additional uncertainty this can cause. However, regrettably, 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.

On 27 June 2001 Ofgem accepted Modification Proposal 0465, *'Amendments to the NTS Entry Capacity Auction Period'*. This modification provided that the forthcoming series of entry capacity auctions (both MSEC and MISEC) would cover the six-month period 1 October 2001 to 31 March 2002. In addition, the modification provided that auctions for MSEC are due to be completed prior to the commencement of the MISEC auctions. In order to enable this change, the MSEC auctions are due to be completed by 31 August 2001 and the MISEC auctions by 15 September 2001. The scheduled commencement date for the MSEC auctions was 13 August 2001, prior to the directions to implement this modification.

On 29 June 2001, following Ofgem's acceptance of Modification 0465, Transco issued its invitation to shippers for the six month auctions from 1 October 2001 to 31 March 2002. This invitation included the quantities of MSEC to be made available to shippers in the auction. Following the release of these quantities a number of shippers have raised concerns regarding the volume of capacity to be auctioned. Subsequently three modifications were raised in response to these concerns, namely Modification Proposal 0477, *'Fifth Round Monthly System Entry Capacity*

Allocation', Modification Proposal 0480, *'Fifth Round Monthly System Entry Capacity Allocation'*, and Modification Proposal 0481, *'Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction'*.

In order to allow participants in the auctions time to properly assess the impact of these proposals and review their bidding strategies, Transco raised this Modification Proposal to delay the forthcoming auctions. Since the raising of this Modification Proposal, Transco has raised a further proposal; 'Modification Proposal 0483, *'Monthly System Entry Capacity Auction Quantity Revision and Capacity Incentive Adjustment'*, which concerns the allocation of capacity offered in the fifth round to different Aggregate System Entry Points and Transco's daily capacity incentive. In addition, Transco has also issued a Pricing Consultation, PC 65, *'Alternative Method of Funding Entry Capacity Constraint Management'* which provides for the creation of a fund drawn from monthly auction income to fund the costs of daily capacity buy-backs.

Ofgem has today issued its decisions on Modification proposals 0477, 0480 and 0481 and has accepted Modification 0481 whilst rejecting Modifications 0477 and 0480. A decision on Modification 0483 will be issued shortly.

The modification proposal

Transco proposes to delay the completion date for the MSEC auctions due to be completed by 31 August 2001 to 10 September 2001. It also proposes to reduce the period of time between auction rounds in both the MSEC and MISEC auctions from two working days to one working day. There would be no change to the date by which the MISEC auctions should be completed by, which would continue to be 15 September 2001.

Under this proposal the next round of MSEC auctions will commence on 29 August 2001

Respondents' views

A majority of respondents supported the implementation of this modification proposal. Of those supporting the proposal, most commented that a delay was necessary to allow participants to assess the impact of any changes that are made to the regime and in the light of the uncertainty surrounding the methodology for releasing winter capacity.

Some respondents in support of the proposal also commented that, irrespective of the proposed changes to the regime, additional time was needed for shippers to consider and evaluate their positions prior to the auctions.

One respondent provided qualified support for the proposal on the basis that the delay was necessary to allow Transco time in which to provide industry participants with a clearer definition of the capacity product they are offering for sale. This participant also indicated that additional time was necessary for Ofgem and Transco to work to ensure that Transco's licence, Gas Act and competition law obligations were met with respect to the auction revenue redistribution mechanism.

One respondent supported a delay of one week to the commencement of the auctions rather than the extended delay proposed by Transco. This respondent suggested that the auctions should be delayed given the uncertainty created by the proliferation of modification proposals. However the respondent indicated it was inappropriate to reduce the number of days between the auctions from two days to one day and as such submitted an alternative timetable for delay that incorporates the existing two working days between rounds.

A number of the respondents opposing the proposal indicated that there was no justification for reducing the time between rounds from two working days to one. One respondent suggested that a move from two days to one day between rounds would lead to an increase in the likelihood of panic buying and an increase in auction prices.

Several respondents to the proposal were also critical of the belated timing of the modification proposals that have been raised concerning MSEC quantities. These participants indicated that these proposals have contributed to shipper uncertainty going into the auctions. One of these respondents suggested that allowing the industry time to reflect on supply and demand fundamentals rather than last minute changes to the auction regime is more likely to lead to acceptable outcomes.

One respondent that opposed the proposal indicated that it would divert industry resources away from developing the regime for the long-term release of capacity.

Ofgem's view

Ofgem believes that the decision on whether to delay the commencement of the auctions is finely balanced. Ofgem accepts that in general, it would be desirable for customers and the industry to

hold the auctions 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 and would provide customers with greater certainty when contracting for gas. However, Ofgem believes that it would not be in customers' or the industry's interests to proceed with auctions if they have not had sufficient time to consider material changes to the regime.

Ofgem remains disappointed that Transco and/or shippers have not sought to address concerns about the current arrangements sufficiently early to allow them to be addressed well before the auctions are due to commence. The issue of the SND methodology and its use to determine MSEC capacity volumes is not new. Ofgem first expressed concern about this methodology and its potential effects prior to the first set of auctions in 1999 and called for its replacement. Ofgem is disappointed that despite frequent calls for the methodology to be replaced, neither shippers nor Transco have sought to raise any proposals to replace the methodology.

As a result, Ofgem considers that a delay to the entry capacity auctions is appropriate, if regrettable to allow the industry additional time to assess and familiarise themselves with the changes to the capacity regime arising from Ofgem's acceptance of Modification 0481, *'Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction'*. In particular shippers will have additional time to refine their bidding strategies in the light of the changes. Further it should also ensure that any changes to the regime can be implemented in advance of the start date for the next round of auctions.

Ofgem notes the concerns raised by some shippers regarding the reduction in the period between auction rounds of two days to one day. Whilst Ofgem continues to believe that at least a two day period is desirable, we believe that it is appropriate to reduce this period to one day in this particular set of auctions. The acceptance of Modification 0481 represents a significant change to auction methodologies. We therefore believe that on balance, this justifies a delay to the commencement date of the auctions to 29 August 2001 even if this is at the expense of the time that shippers will have between rounds to reassess their bidding strategies.

Ofgem's decision

Ofgem believes that this proposal better facilitates the securing of effective competition between relevant shippers and relevant suppliers by allowing additional time for participants in the forthcoming capacity auctions to review their bidding strategies in the light of Ofgem's acceptance of Modification 0481.

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 7 of Transco's Gas Transporter's 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,



Steve Smith
Director, Trading Arrangements