

**OFGEM DECISION LETTER No. 0499**  
"Transition Arrangements for Long Term Capacity Allocation"  
Version 1.0

Direct Dial: 020-7901 7437

31 January 2002

Transco, Shippers and Other Interested Parties

Your Ref:

Our Ref: Net/Cod/Mod/0499

Dear Colleague,

**Modification Proposal 0499 'Transition Arrangements for Long Term Capacity Allocation'**

Ofgem has carefully considered the issues raised in Modification Proposal 0499 '*Transitional Arrangements for Long Term Capacity Allocation*'. Ofgem has decided to accept Transco's revised proposal because we believe that this proposal will 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, February 2001 and September 2001.

Following the acceptance by Ofgem on 19 December 2001 of modification proposal 0505 '*Delay to January 2002 MSEC Allocation*' the next round of MSEC auctions is due to be completed by 28 February 2002.

*Period of allocation*

While the MSEC auctions have to date allocated capacity across a six month period, it was originally envisaged that the third series of auctions, held in August 2000, would allocate entry capacity for a twelve-month period (1 October 2000 to 31 September 2001). However, Modification Proposal 0409, '*Review to monthly auction capacity parameters*', resulted in a continuation of the six-monthly release, recognising that additional time was needed by the industry to evaluate changes to the capacity regime before moving to a longer-term allocation.

In respect of the February 2001 auction, Modification Proposal 0444, '*Extend Capacity Period Sold to 12 months in MSEC and MISEC auctions for February 2001*', proposed auctioning capacity on a twelve-month profile. However, Ofgem rejected the proposal because it did not better facilitate the achievement of the relevant objectives. In doing so, it recognised concerns expressed by respondents. These concerns included uncertainty given the short amount of time available before the commencement of the auction. Respondents to this proposal also expressed a desire to align the period covered by the auction to the gas contracting year commencing in October 2001.

Prior to the September 2001 auctions, British Gas Trading raised Modification proposal 0465, *'Amendments to the NTS Entry Capacity Auction Period'*, which proposed reducing the auction period from 12 months to 6 months. Although Ofgem emphasised its preference for long-term auctions in its decision letter, it nevertheless accepted the proposal on the basis of uncertainties associated with bidding for capacity prior to the resolution of issues surrounding the introduction of long-term capacity auctions from April 2002.

#### *Monthly interruptible system entry capacity*

In addition to conducting MSEC auctions, Transco also conducts Monthly Interruptible System Entry Capacity (MISEC) auctions. The introduction of the MISEC product in November 2000 resulted following Ofgem's acceptance of Modification Proposal 0410, *'Auction of Monthly Interruptible System Entry Capacity'*. Further MISEC auctions have been held along with the MSEC auctions. Modification 410 provided for the release of entry capacity at maximum physical levels through a combination of MSEC and MISEC and followed long standing concerns expressed by Ofgem and industry participants regarding the levels of capacity being brought to market and in particular Transco's Seasonal Normal Demand (SND) methodology.

#### *Determination of 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 methodology was originally introduced as an interim measure for the determination of capacity volumes, but was nevertheless used to determine these volumes for each MSEC auction that has occurred to date, with the exception of the September 2001 auctions in respect of the period October 2001 to March 2002. The major concern with the methodology was that it lacked transparency and resulted in too little capacity being released in the monthly auctions relative to the physical capabilities of the NTS.

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 MSEC to be offered for sale in MSEC auctions for October 2001 to March 2002. This proposal provided for a release based on a proportion of maximum physical capacity levels. In accepting the proposal, Ofgem repeated its concerns regarding the degree of discretion that the SND methodology accorded Transco in determining capacity to be sold in the auctions. Ofgem indicated that it considered that an approach based on maximum physical levels removes the reliance on historical data and the possibility that the SND methodology could artificially restrict the amount of capacity being released to market, potentially influencing bidders' perceptions of constraints and scarcity.

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. In terms of entry capacity volumes, 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. Ofgem is proposing modifications to Transco's 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. These licence amendments will not however be in place by the time of the

forthcoming February 2002 MSEC auctions. It is noted that Transco has today indicated its acceptance in principle of Ofgem's final SO incentive proposals.

#### *Auction rounds*

There are currently five rounds in the MSEC auctions, with 25 per cent of capacity being offered in the first four rounds and any unsold capacity being offered in the fifth round. The fifth round allows for an allocation of capacity between ASEPs in response to shippers' demands, subject to maximum ASEP capacities. 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'*.

#### *'Off the shelf' capacity and daily sales*

As well as monthly capacity rights released in the auctions, Transco may release firm and interruptible capacity on a daily basis where there is additional capacity physically available. A within-day capacity market has also operated since June 2000. In addition, any unsold capacity from the monthly auctions is available as an 'off the shelf' product for purchase up to three days in advance of the beginning of the relevant month.

#### *Ofgem's proposals for Transco's SO incentives*

The SO incentives final proposals are intended to provide financial incentives on Transco to invest in the 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.

As outlined above, the 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, two Network Code Modification Proposals have been raised (Modification Proposal 0500, *'Long Term Capacity Allocation'* and 0508, *'A method of long term capacity allocation'*). Ofgem also intends to consult on changes to Transco's GT licence to specify Transco's entry capacity and other incentives.

### **The initial proposal**

The initial proposal involved the following changes to the entry capacity auctions for the capacity period starting on 1 April 2002:

1. Amend the capacity period which is to be offered for sale in the auction from six months (1 April 2002 to 30 September 2002) to 12 months (1 April 2002 to 30 March 2003);
2. Delay the completion date of the MSEC allocation to 28 February 2002. This aspect of the proposal was consulted on separately in Modification Proposal 0505, *'Delay to the January 2002 MSEC Allocation'* and subsequently implemented.
3. Replace the current process of calculating Determined System Entry Capacity with a reference to the level of capacity required to be offered under Transco's 2002-7 Price Control and to be specified in its GT licence.
4. Reduce the number of auction rounds from five to four, in which 25 per cent of available capacity is offered in each round and any capacity unsold in rounds one to three is offered in round four.
5. Discontinue the later application for MSEC, in which any unsold entry capacity is offered on a first-come-first-served basis, with particular reserve prices applicable.
6. Discontinue the MISEC product.

## **Respondents' views**

Respondents tended to respond separately on each aspect of the proposal, rather than expressing a view about the entirety of the proposal.

### *Capacity period*

An overwhelming majority of respondents did not support the change to a 12-month allocation period.

The majority of those opposing this aspect of the proposal felt that an annual allocation period should coincide with the gas year, which begins in October. This would allow shippers to manage their gas contracts with more certainty about their capacity entitlements. Respondents mentioned the current proposals for the long-term auctions, which relate to the period commencing October 2002 and felt that there should be one more six-month capacity period to coincide with this timing.

A number of these respondents also commented that elements of the long-term regime were uncertain and expressed a desire to finalise the long-term arrangements before moving to allocations of 12 months. One such respondent specifically mentioned Terminal Flow Notices, redistribution and discrimination issues and credit issues as outstanding issues. Another respondent expressed a desire to review consistency between the long-term and medium-term allocation at the earliest opportunity.

One respondent argued that the retention of the six-month allocation period allows for further improvements to be made to the MSEC auction methodology, including more transparency/information provision.

One respondent, while supporting a retention of the current six-month allocation period, argued that if it became apparent that the long-term allocation would not be in place for October 2002, then the effective date for the longer-term auction should be delayed until October 2003. This respondent suggested a deadline of the end of July 2002 for assessing the long-term arrangements. Another respondent suggested that, if there is any prospect that long-term arrangements cannot be delivered until April 2003, the capacity rights up until that time should be offered in a single auction.

The one respondent which supported this aspect of the proposal argued that it would reduce administration costs, without any detrimental effects.

### *Output Measures*

The majority of respondents expressed support for this element of the proposal.

One respondent argued that this would introduce transparency into the process by which the available quantity is calculated, giving shippers more certainty as to future capacity availability. Another respondent said that it would ensure a fair allocation and assist in stabilising capacity prices and any potential impact on gas and other transportation prices.

Several respondents argued that the quantities offered in the auction would need to be included in the Network Code, because the auction will take place before the changes to Transco's GT licence are made. One such respondent commented that this would allow the numbers to be challenged and amended through the modification process.

### *Number of auction rounds*

The majority of respondents supported this part of the proposal, with some respondents making their support conditional on the release of quantities consistent with Ofgem's final SO proposals.

A number of these respondents agreed that the fifth round was unnecessary with the level of capacity that was being made available. One such respondent said that the fifth round was introduced to optimise demand across the ASEPs when the amounts auctioned were based on SND. It said that this optimisation should now be achieved through Transco's actions in operating the system, including its use of buy-backs.

One respondent, while offering support, suggested rolling forward unsold capacity into each round.

#### *Later application for unsold MSEC*

A majority of respondents opposed this aspect of the proposal, instead wanting to retain the facility.

Respondents indicated significant concerns with the removal of the later application for MSEC facility and indicated that it was needed to enable them to purchase unsold MSEC before the day-ahead stage. One respondent argued that the service provides Users with a further opportunity to buy capacity in monthly strips rather than having to bid in DSEC auctions and face the risk of not obtaining capacity on some days. It further suggested that the appropriate price to be paid for this product was the WAP of all accepted bids by month by terminal from the auction. One respondent indicated that the service is necessary in the absence of an effective secondary market for capacity.

A number of respondents also raised a concern which related to Transco's incentive benefits from selling such unsold MSEC in the daily auctions. One respondent said that there was a potential for Transco to unduly benefit if it was able to claw back any under-recovery from unsold MSEC and then also earn incentive revenue from selling the capacity as DSEC. Others felt that it was premature to remove this product before the long-term regime is finalised.

On the other hand, some respondents supported this element of the proposal. One such respondent agreed that there was no continuing need for this product because Transco will be obliged to offer the relevant output measures for sale on implementation of the final SO incentive proposals. This respondent indicated that sales of day-ahead and daily interruptible capacity should ensure that any capacity remaining unsold or which otherwise becomes available is offered to the market. Similarly, one respondent made its support conditional on the applicable output measures being offered for sale and the basis for offering short notice interruptible and firm capacity volumes remaining materially the same over the period to which the next auction relates.

#### *MISEC*

The majority of those respondents that commented on this part of the proposal supported the removal of MISEC, regarding it as no longer necessary, given the volumes of capacity set out in the output measures that will be offered for sale. A number of respondents further argued that MISEC would be likely to undermine the value of and level of participation in the firm product and consequently undermine the value of investment signals coming out of both the auction and the secondary market. One respondent indicated that the only interruptible product to be offered to the market should be a daily 'Use-it-or-lose-it' product as an anti-hoarding mechanism.

One respondent made its support conditional on the assumption that the basis for offering short notice interruptible and firm capacity volumes remained materially the same over the period to which the next auction relates.

A number of respondents did not support the removal of MISEC. One respondent argued that, while the long-term allocation process was still being developed, it was premature to abolish MISEC. Another respondent argued that MISEC is an additional means of acquiring capacity on a longer-term basis that does not incur buy-back costs.

#### *Other issues*

One respondent urged Ofgem to reach a prompt decision on this proposal, in order to allow industry participants to develop appropriate bidding strategies. Similarly, another respondent recommended a period of two weeks between finalising the rules and the start of the auctions, while not compromising the period of two business days between rounds.

The same respondent also suggested that Ofgem's decision on Modification Proposal 507 should be made at the same time as this decision and also commented that there were uncertainties in relation to the buy-back incentive, PC70, the revenue redistribution mechanism and how shippers' share of any buy-back costs would be recovered. Another respondent called for clarity on the treatment of over-recoveries prior to the auctions.

#### **Transco's views**

##### *Capacity period*

In response to the broad support for a six-month allocation, Transco indicated that it would not pursue proposals for a twelve-month allocation period commencing 1 April 2002.

##### *Output Measures*

Transco does not believe that changes to its GT licence envisaged by the final SO incentive proposals will be agreed in time to provide a reference to these provisions in the Network Code. Transco therefore proposed to provide a table of quantities in its Transportation Statement, consistent with the quantities specified in Ofgem's final SO proposals. The Transitional Arrangements of the Network Code would then reference the Transportation Statement accordingly.

##### *Number of auction rounds*

Transco welcomed the proposal to remove the fifth round and recognised that the function of this round was in part intended to enable an optimisation of demand across all ASEPs. It argued that the requirement to offer the output measures for sale would remove the potential for such optimisation. It argued that it was appropriate to offer any unsold capacity remaining from the first three rounds for sale in the fourth round.

##### *Later application for unsold MSEC*

Transco originally argued that this product did not add significant value to the entry capacity regime and that MSEC and DSEC processes should offer adequate opportunity for Users to obtain entry capacity.

However, in response to the concerns raised by respondents, Transco withdrew this element from the proposal. It stated that it has proposed to replace this product with a rolling MSEC process for the long-term allocation process, as part of Modification Proposal 500, which is currently out for consultation.

#### **MISEC**

Transco argued that MISEC was created to overcome industry concerns about the SND methodology and given that Transco proposes to replace that methodology with one based

on offering the level of output measures for sale, the continuation of MISEC is no longer necessary.

### **Revised proposal**

Transco amended its proposal in response to views put forward on the initial proposal. The amended proposal involves the following changes to the entry capacity auctions for the capacity period starting on 1 April 2002:

1. Transco has proposed that the baseline capacity quantities to be offered for sale, consistent with the final SO incentive proposals, will be published in its Transportation Statement and that the Transitional Arrangements of the Network Code will refer to the quantities published in this statement.
2. Transco has proposed reducing the number of auction rounds from five to four, in which 25 per cent of available capacity is offered in each round and any capacity unsold in rounds one to three is offered in round four.
3. Transco has proposed that the provision of MISEC be discontinued.

### **Ofgem's views**

#### *Capacity period*

Ofgem has consistently stated its preference to see longer-term auctions of entry capacity. In our decisions on previous proposals relating to whether capacity should be auctioned over six or twelve months, Ofgem has repeated its preference for longer-term auctions in order to provide improved price signals to Transco for investment in the NTS and to allow shippers to secure longer-term entry capacity rights. Ofgem also considers that the introduction of longer-term auctions would provide shippers with a higher degree of certainty and stability regarding the structure of the entry capacity regime.

However, Ofgem recognises the preference on the part of respondents to finalise the arrangements for the longer-term regime before extending the capacity period auctioned and understands the decision by Transco to remove this element from the proposal, in response to respondents' views.

#### *Output Measures*

Under Transco's TO price control for 2002-7, Transco's allowed revenues have, for the first time, been set against explicit measures of entry and exit capacity outputs for each of the five years of the price control. The output measures have been set on the basis of maximum physical capacity levels of the NTS. Under Ofgem's final SO proposals, Transco will be obliged to offer for sale 90 per cent of these winter output measures. This approach addresses the weaknesses in the previous SND methodology of determining capacity release and ensures a transparent release of capacity at levels close to physical capabilities. In particular, as Ofgem indicated in its decision on modification proposal 0481, this approach removes the possibility that scarce capacity is allocated to terminals not on the basis of price but on the basis of alternative artificial allocation mechanisms such as SND.

Ofgem intends to specify Transco's requirement to offer these levels of capacity in Transco's GT Licence. However, as indicated by both Transco and respondents, this obligation will not be in place before the forthcoming entry capacity auctions. Ofgem therefore welcomes Transco's amended proposal to specify the level of outputs in its Transportation Statement, consistent with Ofgem's final SO proposals and to reference the Transportation Statement in the Network Code. As explained in our final SO proposals, these levels are 90 per cent of the TO winter baseline output measures and are presented in Appendix 1 of the December SO document.

### *Number of auction rounds*

The fifth round in the capacity auctions 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 has the highest value. It also ensured that any unsold capacity was made available to the market.

Ofgem accepts that Transco's requirement to offer for sale a minimum level of output measures at each terminal at levels close to maximum physical capacity, removes the rationale for the fifth round. Instead, under an approach to releasing capacity that is linked to the maximum physical levels, allocation between terminals will be optimised through a combination of the primary allocation and secondary markets, including capacity buy-backs. In addition, Ofgem notes that levels of unsold capacity will continue to be offered in the fourth round.

### *Later application for MSEC*

Ofgem notes the concerns raised by respondents to Transco's initial proposal to discontinue the 'off-the-shelf' MSEC product and that Transco has altered its proposal to remove this element.

### *MISEC*

The rationale for the introduction of the MISEC product was to ensure a release of capacity at maximum physical levels through a combined release of firm and interruptible capacity products. In the light of Transco's agreement to offer for sale the baseline capacity measures outlined in Ofgem's SO Incentives final proposals document, which will ensure a release of firm capacity at close to maximum physical levels, Ofgem agrees that the continued use of the MISEC product is no longer warranted.

### **Ofgem's decision**

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

Ofgem believes that the proposal for Transco to offer for sale in the upcoming auction levels of capacity consistent with Ofgem's final SO proposals should ensure the economic and efficient operation of the pipeline system by identifying the true location of system constraints through the secondary and buy-back markets and by encouraging Transco to discover its ability to manage the costs of a constraint through taking buy-back actions at terminals.

Ofgem also believes that the proposals to release these levels of capacity should better facilitate the securing of effective competition by ensuring that prices at different terminals reflect actual demand and supply at different locations.

Ofgem considers that the removal of the fifth round and the MISEC product will better facilitate the efficient and economic operation of the pipeline system as these services are no longer necessary within the context of a release of capacity based on maximum physical levels.

Accordingly, Ofgem had decided to consent to this modification, because we believe that it will better facilitate the achievement of the relevant objectives as outlined in Standard Condition 9 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,

Mark Feather  
**Head of New Gas Trading Arrangements**