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Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/477/480/481/483

Dear Colleague,

Ofgem decision - Winter 2001 Capacity Auction modifications

Ofgem has carefully considered the issues raised in the following modification proposals

- Modification Proposal 0477 *'Fifth Round Monthly* System *Entry Capacity Allocation'*
- Modification Proposal 0480 *'Fifth Round Monthly* System *Entry Capacity Allocation'*
- Modification Proposal 0481 *'Release of ASEP* Maximum *System Entry Capacity Volumes for MSEC* Auction'
- Modification Proposal 0483 *'MSEC Auction Quantity Revision and* Capacity *Incentive Adjustment'*

Ofgem has decided not to direct Transco to implement Modification Proposals 0477, 0480 and 0483.

Of gem has directed Transco to implement Modification Proposal 0481 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 issues raised in the following modification proposals and give the reasons for making our decisions.

Background to the proposals

In September 1999, Transco conducted the first auctions for the sale of Monthly System Entry Capacity (MSEC) to the National Transmission System (NTS), The monthly auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000), Further MSEC auctions were held in March 2000, August 2000 and February 2001.

In addition to holding monthly auctions, Transco makes firm and interruptible capacity available on a daily basis where there is additional capacity physically available on the day. In the event of a constraint at an entry point (when physical capacity available is less than capacity sold against which gas is flowing) Transco can buy-back capacity until the constraint is relieved. Transco has financial incentives, set out in the Network Code, which are designed to ensure that it releases all physically available entry capacity to market by selling additional capacity day-ahead and within-day. The incentive is also designed to ensure that Transco manages the costs of any buy-backs by exposing it to a proportion of any buy back costs incurred.

Under the incentives, Transco retains 20% of any additional revenue associated with the sale of daily firm and interruptible capacity. Conversely, Transco is liable for 20% of the costs of buying back capacity in the event of a constraint. Transco's gains and losses under the scheme are capped at £5m and divided into equal monthly caps. The incentive arrangements were introduced in October 1999 and were set on the basis of the risks/rewards associated with using the Seasonal Normal Demand (SND) methodology to determine the proportion of available capacity to be released in the monthly (rather than the daily) auctions. As the SND methodology attempted to determine likely capacity availability under seasonal normal temperatures, the incentive was constructed around a zero mean. With Transco releasing SND capacity in the monthly auctions, it was judged at the time that the risks of any buy-backs were offset by the rewards associated with incremental sales.

In the first year of its incentive scheme, Transco's net reward under the scheme was approximately £3.2m. In the second year of its incentive scheme, to date (from 1 October 2000 to 30 June 2001), Transco has lost approximately £235 000.

Under the daily regime, holders of MSEC capacity across all terminals bear 80% of the costs of capacity buy-backs in proportion to their holdings of capacity. Conversely, holders of MSEC at individual Aggregate System Entry Points (ASEPs) receive 80% of the revenues associated with sales of daily capacity at these individual ASEPs.

Discussion of recent MSEC modifications

Following tile September 1999 entry capacity auction a number of modifications to the auction regime were proposed to address issues that were unresolved prior to the introduction of the auctions in October 1999.

One of the main areas of concern was that the existing allocation methodology resulted in too little capacity being released in the monthly auctions relative to the physical capabilities of the NTS. Under the entry capacity regime, MSEC quantities are determined through the application 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.

It was recognised prior to the introduction of the auctions that the SND methodology was flawed and should be only be adopted as an interim measure for the determination of MSEC volumes. In our September 1999 decision document[1], Ofgem stated that:

'Of gem has, however, already made clear that the proposed methodology for determining aggregate capacity and for allocating that capacity to terminals will need to be *replaced for subsequent auctions, Of gem recognises the problems* associated *with basing the methodology* on *historical data and SND profiles. Given that Transco prepares the SND forecasts,* Of *gem does not believe that it will* be *appropriate in subsequent years* to *use SND* as *the basis for the methodology* to determine *capacity* to *be sold. The new methodology will need* to *be based* on a *more robust, independently verifiable measure* of *capacity.'*

In response to concerns following the September 1999 auctions regarding MSEC volumes and the allocation of these volumes between terminals, two modifications were raised by Transco, Modification 0371, *'Shipper Determination of Entry Capacity Profiles',* and Modification 380, *'Increased Availability* of *Monthly System Entry Capacity'.*

Modification 380 increased the volume of capacity made available in the monthly auction to all entry terminals by increasing MSEC volumes to 110% of SND levels. Of gem accepted this modification on 28 February 2000 on the basis that it represented an improvement of the current regime, allowing additional capacity to be made available at all terminals in the monthly auctions including those that were not allocated capacity under the SND methodology (onshore terminals). However, in it is decision Of gem restated its concerns and referred to the interim nature of the SND methodology and again noted that a key weakness of the SND methodology was its reliance on historical flows and its inability to reflect future adjustments in flow profiles.

Of gem also stated in its decision that the methodology for determining capacity at each terminal in the monthly auctions should be linked to the maximum physical capacity available at each terminal, with Transco buying back capacity in the event of a constraint.

Modification 371 provides shippers with a degree of flexibility in determining the allocation of monthly entry capacity amongst terminals. This proposal was raised in response to concerns that the existing allocation methodology uses historic terminal flow data to determine capacity allocations and does not account for market changes into the future. Under this proposal, any capacity that remained unsold in the first four rounds of the auction would be allocated in the fifth round, subject to the maximum ASEP capacity amounts determined by Transco at each terminal. Of gem accepted this modification on 28 February 2000, 0/1 the basis that the fifth round would ensure that all unsold monthly capacity is offered al: other terminals and allocated to those terminals where it was valued the most, subject to ASEP maximums. This would also ensure that all unsold monthly capacity continued to be made available and would not be effectively withheld from the market.

Transco held a further series of monthly entry capacity auctions in March 2000. In these auctions, weighted average prices paid by shippers significantly exceeded reserve prices, resulting in a substantial revenue over-recovery for Transco. Following these auctions concerns were again raised that insufficient entry capacity was being made available in the MSEC auctions. In response to these concerns Ofgem released a discussion paper entitled, *'Entry Capacity Regime for October 2000:* A *discussion paper'.* This paper outlined a number of possible changes to the regime to ensure that all available NTS entry capacity is brought to market on a non-discriminatory basis. One option raised by the paper was a maximum physical release of capacity to the market. In outlining this option Ofgem repeated its view that under a maximum physical release shippers could be certain that all capacity was released to market in the monthly allocation.

Whilst this would ensure that all capacity is released to the market in the monthly allocation, several shippers raised concerns that a maximum physical release could lead to a re-occurrence of the problems that occurred at St Fergus during the summer and autumn of 1998.

Following the release of this paper and an assessment of shipper views, Transco raised Modification Proposal 410, *'Auction of Monthly Interruptible System Entry Capacity'.* Ofgem accepted this proposal on 21 July 2000. This modification provided for the release of entry capacity at maximum physical levels through a combination of monthly firm and monthly interruptible products. In accepting this modification Ofgem recognised the concerns raised by shippers that overselling of firm entry capacity could lead to a situation where shippers sought to exploit constraints at terminals through their nomination behaviour creating large costs in the buy-back market.

However, as had been made clear in the conclusions of our investigation into events at St Fergus and Bacton in 1998[2,] Ofgem believed that shippers who sought to exacerbate the costs associated with constraints by using their nominations to give a false impression of the amount of gas they intended to land, could be in breach of their licence. Indeed, one shipper was found to be in breach of its licence for consistently nominating in excess of its intended flows. Of gem made clear that it would continue to monitor shippers' behaviour under the new regime and would take enforcement action where companies were found to be seeking to manipulate prices or 'game' the new arrangements.

Since Of gem's acceptance of Modification 410, there have been two further auL"1ions of MSEC and monthly system interruptible entry capacity (MISEC) products. In respect of MSEC these auctions occurred for the period 1 October 2000 to 31 March 2001 and 1 April 2001 to 30 September 2001. The first of auction of monthly interruptible system entry capacity ('MISEC') was held in November 2000 for a period of 4 months December 2000 to March 2001. The second MISEC auction was held in March 2001, for a period of six months, from April 2001 to October 2001.

In both the winter 2000/1 and summer 2001 capacity auctions Transco incurred significant revenue over recoveries with weighted average prices at most terminals in excess of reserve prices. In this context, participants have continued to raise

[1] *'The New* Gas *Trading Arrangements:* A *decision document',* Ofgem, September 1999

[2] St Fergus and Bacton Investigation: A report under Section 39(4) of the Gas Act 1986. Of gem I December 1999'

concerns regarding whether sufficient monthly firm capacity is being brought to market in the monthly auctions. Concerns have also been raised about whether Transco sells sufficient within day firm capacity, particularly on days where interruptible capacity has been interrupted. Concerns have also been expressed about the frequency and volume of interruptions called by Transco and the increased use of Terminal Flow Advice ([FA) notices by Transco.

Inter-terminal capacity substitutability

In October 2000, Transco experienced the first significant capacity constraints mainly at the St Fergus terminal. Transco indicated that the constraints were the result of lower demand in GB as a result of higher than average temperatures for the month. Lower demand reduced the ability of Transco to evacuate gas at Northern terminals (and particularly at 5t Fergus). In October 2000, Transco bought back significant levels of capacity often at prices significantly higher than the price at which the capacity was sold in the auctions. Buy-back costs of £8.5 million were incurred during the month. In these circumstances, Transco attempted to alleviate the constraint at the St Fergus terminal by purchasing capacity at Teesside and Barrow. This suggested the existence of some degree of interdependencies and substitutability between these terminals.

More recently, as part of its *'Transporting Britain's Energy'* consultation process, Transco has highlighted the physical interdependencies of the three terminals of the Northern Triangle[3], showing that capacity availability in the triangle or at one particular terminal can be maximised with appropriate transfers of gas between the three terminals. In general, Transco's analysis suggests that the capacity physically available at one terminal is a function of the capacity used at the other terminals.

Transco release of MSEC quantities -June 2001

On 29 June 2001 Transco issued an invitation to shippers to participate in the auction for the capacity period October 2001 to March 2002. This invitation included the amount of MSEC to be offered for sale in the auction.

Following the release of these quantities, shippers, Of gem and customers have all raised a number of concerns regarding the volumes of capacity on offer. Transco's proposed MSEC volumes were significantly less than those quantities that were made available in the October 2000 to March 2001 auctions at certain terminals. In particular, a number of these shippers have indicated that the volumes of MSEC released by Tral1sco are too low and do not reflect the physical capabilities of the NTS. Shippers have expressed concern that this will create an impression of scarce capacity and constraints and that this may lead to higher prices and a large over-recovery from the auctions.

In the light of the concerns regarding the MSEC quantities Modification proposals 0477,0480,0481 and 0483 have been raised. These modifications are the subject of this decision.

Transco has also recently raised Pricing Consultation PC65, *'Capacity Auction Revenue Redistribution Mechanism',* This paper proposes an amendment to the existing auction over and under-recovery mechanism. The proposals provide for auction over-recoveries to be diverted into a fund that is to be used to offset the costs of entry capacity buy-backs undertaken by Transco during periods of system constraints. Transco has recently completed a consultation on this proposal and will be releasing its decision on whether or not to proceed with the proposal (or a revised proposal) in the light of the responses it has received shortly.

The modification proposals

Modification Proposal 0477 'Fifth Round Monthly System Entry Capacity Allocation'

The modification proposal provides that 90% of Determined Monthly System Entry Capacity will be offered in equal sized tranches in the first four rounds of Transco's NTS MSEC auctions. The proposal further provides that the remaining 10% of Determined Monthly System Entry Capacity will be offered in round five together with any quantities of unsold capacity from the preceding rounds.

Under this modification proposal, the Network Code rules for operating round 5 will remain unchanged from the present arrangements in all other respects. Furthermore, the proposal does not seek to change the method of calculating Determined Monthly System Entry Capacity or Available Monthly Capacity at each Aggregate System Entry Point (ASEP). The modification is intended to increase the level of competition for MSEC, enabling larger quantities to be offered in what is known as the fifth 'flexible' round of MSEC auctions.

Modification Proposal 0480 'Fifth Round Monthly System Entry Capacity Allocation'

The modification proposal provides that the current published volumes of Determined System Entry Capacity will be increased from SND+ 10% to SND+20% and that the incremental volume will be added to any unsold capacity from the initial four rounds and made available in the fifth 'flexible' auction round. Further, it is proposed that the current published volumes of Determined System Entry Capacity be offered in equal sized tranches in the initial four rounds of the auction.

Under this modification proposal, the Network Code rules for operating round 5 will remain unchanged from the present arrangements in all other respects. The modification is intended to increase the level of competition for MSEC and to enable larger quantities of MSEC to be offered in the fifth auction round.

Modification Proposal 0481 'Release of *ASEP Maximum System Entry Capacity* Volumes *for MSEC Auction'*

[3] the three terminals are St. Fergus, Teesside and Barrow

The modification proposal provides for the release of Monthly System Entry Capacity (MSEC) quantities for each Aggregate System Entry Point (ASEP) for each month equivalent to the highest of the monthly ASEP Maximum System Entry Capacities published by Transco in its auction invitation letter on 29 June 2001.

The modification further provides that the volumes of capacity be auctioned over 4 rounds and any quantities of unsold capacity from these four rounds be offered in round 5 in accordance with the existing Network Code rules. Under this modification proposal, the MISEC, Daily System Entry Capacity (DSEC) and Daily Interruptible System Entry Capacity (DISEC) capacity auctions would also remain to cover unsold volumes and Use-it-or-lose-it (UIOLI) capacity on the day.

This modification is intended to increase the volume of capacity released in the monthly auctions 'within the reasonable bounds of what shippers believe Transco may be able to make physically available on th(~ day, without making assumptions about the level of demand or distribution of supplies at entry points'. Finally, the proposal is intended to apply only to the forthcoming winter 2001/2002 auctions.

Modification Proposal 0483 'MSEC Auction Quantity Revision and *Capacity Incentive Adjustment'*

This modification proposal provides for the release of MSEC at SND+ 10% levels with 90% of this quantity being offered in equal sized tranches for rounds 1 to 4 of the MSEC auctions. The proposal provides that the remaining 10% of capacity will be offered in round 5 in addition to any quantities remaining unsold from the preceding auction rounds with Transco being able to increase capacity availability at individual ASEPs in this round at the St Fergus, Teeside and Barrow terminals subject to the application of a group maximum for these terminals.

Transco envisages that implementation of this approach to round 5 quantities may increase the quantities sold in the auction at one or more terminals within the proposed St Fergus, Teeside and Barrow combination. In particular Transco has suggested that the approach should facilitate the potential sale of higher levels of individual ASEP capacity than would have been the case at terminals within the defined St Fergus, Teeside and Barrow combination.

Transco has indicated that the proposal reduces the potential for incremental sales of Daily System Entry Capacity at particular terminals but increases the flexibility in round 5 for scarce capacity to be diverted to terminals on the basis of the price shippers are willing to pay. As a result of the potential reduction in daily revenues from incremental sales at higher priced terminals, Transco also proposes through Modification Proposal 483 an adjustment to Transco's capacity incentive arrangements to reflect this potential change in the balance of risk and reward.

Under the proposed adjustment, where the actual allocation of MSEC at an individual ASEP (Barrow, St Fergus or Teeside) exceeds the maximum allocation that is possible, when applying the proposed group limit on a pro-rata basis then a monthly compensatory sum will be made available to Transco under its incentive. Transco indicates that the pro-rata quantities equal the maximum capacity availability at each of St Fergus, Barrow, Teeside as specified in the existing MSEC auction volumes. Transco state that the compensatory amount shall equal the existing Daily System Entry Capacity reserve price multiplied by the incremental quantity identified for the relevant month, multiplied by 20%. Transco further proposes that the monthly sum be drawn from the balance of monies received from the sale of Daily Capacity.

When the monthly compensatory sum is less than the aggregate amount of relevant capacity incentive revenue, which Transco would normally have distributed to the holders of MSEC at each ASEP (i,e. 80% of incentive revenue), Transco proposes to deduct the monthly sum from the relevant capacity incentive revenue and re-distribute the remaining amount of revenue to holders of MSEC in proportion to the revenue received for Daily Capacity services at each ASEP. If the sum is not available in its entirety in the required month then the residual sum is rolled over to the following month. Transco also indicates that if it is unable to collect the sum of the monthly sums an 'ad hoc' invoice will be issued to capacity holders to facilitate the collection of outstanding amounts.

Respondents' views

Modification Proposal 0477 'Fifth Round Monthly System Entry Capacity Allocation'

A clear majority of respondents did not support the modification proposal. Most of the respondents who opposed the modification stated that a reduction of capacity in the initial four auction rounds will increase the perception that capacity is scarce, leading to higher bid prices. Some respondents argued that higher bid prices would be experienced in round 1 to 4, as shippers may not wish to risk waiting until the fifth round to secure their capacity requirements at a specific terminal.

A number of respondents noted that, as the proposal did not increase the ASEP maximum capacity levels, there would be limited benefits for the regime, arguing that this may lead to steeper price escalation at terminals where capacity is perceived to be constrained. A further respondent highlighted that in previous auctions significant price escalation has been observed in the earlier rather than the later rounds. The respondent considered that this modification is likely to accentuate this trend.

More generally, several respondents commented that the modification could lead to revenue over- recovery by reducing available capacity in the first four rounds and increasing uncertainty and price volatility. According to these respondents, this would aggravate the distortionary effect of the existing revenue re-distribution mechanism.

Another respondent indicated that the modification fails to address distortions associated with the existing regime and does not address an absence of transparency regarding the quantities made available by Transco through both the monthly and daily auctions.

A number of respondents welcomed the intention of the proposal to increase flexibility in the way in which MSEC is allocated between terminals and supported the principle of increasing the importance of forward looking rather than historic gas flow data for determining the quantities of capacity released at each ASEPs. One of these respondents noted that the proposal could have the advantage of making available 10% of capacity from low price ASEPs to those ASEPs where shippers are willing to pay higher prices. However, this respondent also maintained that the modification proposal is likely to result in higher bid prices in the initial four auction rounds.

The respondent who supported the modification stated that the proposal would provide shippers with greater flexibility to choose the entry point at which they wish capacity to be made available. This respondent argued that this would increase the capacity made available at St Fergus and may therefore reduce the level of prices bid for St Fergus capacity. However, this respondent noted that this approach only has merit to the extent that Transco is able to substitute real physical capacity from Barrow and Teesside to St Fergus. If the proposal simply resulted in a transfer of capacity from southern terminals, which have little inter-dependence with St Fergus, then the modification would merely cause capacity overselling, thus increasing the probability of buy-back actions.

Modification Proposal 0480 'Fifth Round Monthly System Entry Capacity Allocation'

A clear majority of respondents opposed the modification. Of those respondents who did not support the modification, the majority indicated that the proposals represented only a marginal improvement on the current methodology, as shippers' flexibility to allocate capacity in the fifth round is limited by the ASEP maximum capacity amounts. One shipper stated that the proposal might not even increase competition at non-competitive terminals, but could instead increase the aggression of competition at more competitive and constrained terminals, such as St Fergus.

[he majority of respondents accepted that, in contrast to modification 0477, modification 0480 has the advantage of increasing the volume of capacity released in the fifth round without reducing the volumes made available in the initial four rounds. This would potentially reduce shippers' perception that capacity is scarce in the earlier rounds and provide shippers with increased flexibility to allocate the additional capacity to those terminals where they valued it most.

A number of respondents have suggested that the proposal may increase the probability of Transco buying back capacity or Transco's use of TFAs. In this respect, one respondent stated that the arbitrary nature of an SND + 20% methodology fails to account for the capacity capability at each terminal. Hence, an increase in the probability of buy backs due to the larger capacity release would be borne by MSEC holders on a non-ASEP specific basis. One of these respondents noted that an overselling of capacity by Transco would not only increase the likelihood of buy-back costs but would also reduce incremental capacity available day ahead. This could in turn skew Transco's capacity incentive towards more buy-back costs.

One shipper maintained that the proposal does not address the fundamental problem with the current auction methodology, i.e. the fact that the amount of capacity released in the auction is unable to satisfy demand. A number of respondents commented that this shortage of capacity is putting upward pressure on bid prices, which may lead to further revenue over-recoveries by Transco.

Modification Proposal 0481 'Release *of ASEP Maximum* System *Entry* Capacity *Volumes for MSEC Auction'*

The majority of respondents supported the modification proposal. Most of the respondents in favour of the proposal stated that the release of additional volumes of capacity would address the market perception that capacity is scarce. According to some of these respondents, this perception has been exacerbated by the reliance on historic terminal flow data, which characterises the current SND methodology. Some respondents also stressed that the proposed approach offers a simple and transparent method of releasing capacity.

Several respondents in support of the proposal stated that, by increasing the amount of capacity available for auctions, market confidence will improve and prices bid at the auction will decrease. This, in turn, will diminish the likelihood of large Transco revenue over-recoveries. In this respect, one respondent stated that this proposal, by minimising over-recoveries, would alleviate concerns surrounding the current rules for redistributing the over-recovery.

A number of shippers supporting the proposal indicated that the risk of additional buy-back costs arising from the proposal may be exaggerated as Transco will have the ability to explore choices in managing the costs of any buy-back actions and may buy-back capacity at cheaper terminals to address constraints. These respondents suggested that Transco could use the flexibility among northern terminals to reduce constraints costs.

One respondent stated that the likely overall costs to the industry of combined capacity charges and buy- back would be lower under this proposal than under the existing methodology as capacity prices will be substantially reduced by the larger release of capacity.

One respondent suggested that the creation of a buy-back fund might allay industry concerns about the level of any capacity smear associated with increased volumes of buy-back.

Another respondent suggested that the proposal might clarify the level and location of constraints in the NTS.

A number of respondents stated that the additional capacity released at the auctions under this proposal should have the benefit of increasing liquidity and moderate prices in the secondary and buy-back capacity markets.

Most of the respondents who did not support the modification argued that the proposal would significantly increase buy-back costs and risks. All of them expressed reservations in implementing this modification in time for the next capacity auctions, with several arguing that such a substantial change in the regime whilst shippers are currently preparing their bidding strategies based on an SND+ 10% release of capacity would create market uncertainty. Some respondents highlighted that the potential increase in the probability of buy-backs will be borne by MSEC holders on a non-ASEP specific basis, thus potentially discriminating in favour of St Fergus shippers.

One shipper expressed concern that too much reliance on the buy-back market could induce market players to factor in the high potential for buy-backs into their bids in the auctions, inflating demand rather than deflating any perception of scarcity. This respondent also argued that a move to such a change in the regime is inappropriate until Of gem has published the results of its capacity investigation.

Other respondents commented that it is uncertain whether the proposal would reduce the level of bid prices and, in turn, over-recoveries. These respondents indicated that shippers might bid for more capacity than they need to insure themselves against scale-backs or to obtain a commercial opportunity to earn buy-back revenue.

Finally, a number of respondents who oppose the modification stated that the proposal fails to assess tl1e impact of releasing additional quantities on Transco's incentives and the smear back on shippers associated with daily capacity buy-backs.

Modification proposal 0483 'MSEC Auction Quantity Revision and Capacity Incentive Adjustment'

All of the respondents to this modification opposed its implementation for the forthcoming auctions.
Most respondents repeated the views they had expressed in response to Modification proposal 0477 that the proposal by decreasing the volumes made available in the first four rounds will escalate bid prices and increase the possibility of an over-recovery. A number of shippers commented that it would increase shippers' perception of capacity as a constrained product. In this context several respondents reiterated their support for modification proposal 481 on the basis that it addresses their concerns that insufficient capacity volumes are being made available in the auctions.

Some respondents also commented that shippers who have secured capacity at terminals other than St Fergus would be able to secure their capacity at lower prices in the first four rounds and will continue to hold significant advantages over those shippers purchasing capacity at St Fergus.

One respondent indicated that it supported the objectives of the proposal to enable shippers to secure capacity where it is most highly valued but considered that it was inappropriate to make a significant change to the capacity product at such a late stage.

One respondent expressed its support for the flexible allocation of capacity advocated by the proposal as it should enable Transco to configure its system more efficiently to reflect shipper preferences. However this respondent indicated that the proposal should not be implemented for the forthcoming auctior1s. The respondent indicated that it wished to avoid delays to the auction timetable and believed that consideration of this proposal would delay the auctions further.

Another respondent indicated that it would favour the increase in Northern Terminal capacities and stated that this element of the modification should be approved with the remainder of the au(.1ion rules staying the same thus ensuring that 100% of MSEC volumes are released in rounds 1 to 4.

One respondent indicated that in the absence of any changes to the buy-back mechanism, shippers at Teeside and Barrow will pay more for capacity and will also bear a significant proportion of buy-back costs.

Several respondents also commented on the daily incentive element of the proposal. These respondents all opposed any adjustment to Transco's incentive. In commenting on the proposal a number of respondents stated that Transco's flexible round proposal would reduce its risks in the buy-back market. It was therefore argued that any change to the capacity incentive is not justified. One respondent indicated that there was no justification for raising the modification proposal at such a late stage. This respondent indicated that proposing a fundamental change to the incentive regime at such a late stage constitutes an abuse of Network Code consultation processes.

Transco's view

Modification Proposal 0477 'Fifth Round Monthly System Entry Capacity Allocation'

Transco recognised the concerns expressed by the majority of respondents regarding the potential for an escalation of prices and, as such, indicated that it does not support the implementation of this modification proposal.

Modification Proposal 0480 'Fifth Round Monthly System Entry Capacity Allocation'

Transco does not support this modification. In particular, it believes that the proposal would increase the probability of buy-back actions, while reducing the sale of incremental entry capacity. Transco stated that this potential result would represent a significant change of the risk/reward profile for both Transco and shippers under the current capacity incentive regime. In this respect, Transco accepts that this could be mitigated by a re-assessment of the format of the capacity incentive regime, but does not believe that there is adequate time to amend it in time for the commencement of the next series of capacity auctions.

Modification Proposal 0481 'Release of *ASEP Maximum System Entry Capacity Volumes* for *MSEC Au(:tion'*

Transco does not support this modification. In particular, Transco stated that the proposal would produce a substantial shift in MSEC availability and the consequences of this change should be considered in relation to all other aspects of the capacity regime. It also believes that an increase in the volume of capacity released to the ASEP maximum system entry capacity levels could increase the likelihood of capacity constraints leading to high buy-back costs and a reduced potential for incremental daily sales of entry capacity.

In this context Transco indicated that the buy-back market is illiquid and that buy-back prices are significantly marked up to Transco in the buy-back market. Transco also argued that the costs of buying back capacity would be significantly larger than recently experienced with Transco having to buy back significant volumes at escalating prices before seeing significant changes in gas flows.

Transco stated that the modification would represent a significant change to the risk/reward profile for both Transco and users under the current capacity incentive regime. Transco accepted that this could be mitigated by a re-assessment of the format of the capacity incentive but also argued that there is not. sufficient time to carry this out before the commencement of the next set of entry capacity auctions. In general, Transco is of the opinion that the significant magnitude of the proposed change needs to be fully discussed prior to implementation and the limited consultation of this proposal does not satisfy this requirement.

In Transco's view the proposal is not likely to facilitate the relevant objectives. In particular, Transco stated that selling capacity beyond physical capability would remove useful signals of shippers' capacity requirements. Moreover, overselling capacity would require Transco to exercise greater judgement as to the location of expe(::ted shipper nominations when planning its operations. Transco also argued that an over provision of capacity could remove the scarcity that created the need for an allocation process based on auctions. Transco suggested that instances of 'no scarcity' are best addressed through the provision of cost reflective charges rather than discounted reserve prices. Transco maintained that a combination of discounted prices and over provision of capacity would imply that capacity could be available at a substantial discount to marginal costs.

Modification proposal 0483 'MSEC Auction Quantity Revision and Capacity Incentive Adjustment

Transco has indicated that it supports the implementation of this modification proposal. Transco considers that the proposal if implemented should enable greater opportunity for shippers to secure entry capacity at the places where shippers value it the most highly thus promoting shipper to shipper competition. Transco considers that this will improve the efficiency of the auctions and in turn further the economic and efficient use of the pipeline system and promote effective competition between users.

Ofgem's View

Ofgem has carefully considered the issues raised by Transco and respondents regarding the likely effects of the implementation of these modifications. As a matter of practicality, Of gem considers that it is not possible to recommend implementation of all of the four modifications being considered in this decision.

Consequently, Ofgem has decided to implement the proposal that it considers best facilitates the achievement of the objectives outlined in Standard Condition 7 of the Gas Transporter's licence.

Ofgem shares the concerns raised by a number of respondents about the raising of a number of modifications that, if implemented, would lead to potentially significant changes to the capacity arrangements immediately prior to the commencement of the winter auctions. Of gem remains disappointed that Transco and shippers have not sought to address, in a more timely fashion, the weaknesses associated with the SND methodology that have been highlighted repeatedly for over two years.

However, in reaching its decisions on the various modification proposals before it, Ofgem has had to balance (amongst other things) carefully the need for shippers and customers to have sufficient time to consider the implications of any rule changes and the general desirability of stability in the auction rules and regime against the harm to customers and competition that may occur if clear deficiencies in the arrangements are not dealt with through rules changes.

Ofgem agrees with the concerns expressed by many respondents regarding the historically based nature of the SND methodology that is currently used to determine the quantities of capacity to be made available at each ASEP. Of gem has consistently made clear, both prior to the commencement of the first auctions and subsequently, that it did not support the use of the SND methodology on an ongoing basis. Ofgem has also consistently supported the use of a capacity release based on the maximum physical capacity of each terminal as in our view this is the only reasonably robust and verifiable measure of actual capacity at each entry point.

Ofgem has also expressed its concern about the discretion that the SND methodology accords Transco in determining capacity to be sold in the monthly auctions. As the proportion of capacity to be sold in the monthly auctions affects the risks and reward profile under Transco's incentive scheme, this has been a source of some concern to Ofgem.

Ofgem therefore continues to prefer an approach for releasing capacity that is linked to the maximum physical capacity available (or a proportion thereof) at each terminal with Transco buying back capacity in the event of a constraint. In particular, Ofgem believes that a maximum physical capacity (or a proportion thereof) approach is the most simple and transparent method of releasing capacity and reduces any Transco discretion in determining how much capacity to release. O{gem considers that such an approach removes the existing reliance on historical data and the possibility that a historically based methodology could artificially restrict the amount of capacity being released to market. It also removes the possibility that scarce capacity is allocated to terminals not on the basis of price but on the basis of an artificial allocation mechanism. In addition it also removes the need for Transco to determine, under the methodology, non-transparent limits on the amount of capacity that can be sold in each month and at each terminal in the fifth round.

Ofgem accepts that a release based on maximum physical capacity may increase the probability of buy- back actions if the network is constrained this winter. However, in a competitive market any buy-back costs should simply reflect the value of capacity under constrained conditions. The value of capacity would be established in secondary markets under any capacity release and so it is not clear to Ofgem that the total costs associated with the constraints would rise if a proportion of maximum physical capacity is sold in the primary release.

Ofgem does not believe that it would be appropriate, or consistent with the relevant objectives to artificially constrain monthly capacity release as a result of assertions that the market is illiquid or that shippers may seek to exploit constraints. Ofgem believes that such conduct is more properly dealt with through appropriate regulatory action and has issued guidance[4] to shippers on acceptable and unacceptable conduct in the buy back market.

Ofgem recognises that modification proposal 0481 may change the balance of risk and reward under the current capacity incentive regime and, if this is the case, believes that an adjustment to Transco's capacity incentive may be appropriate. Ofgem does not accept the argument raised by Transco that it is too late to address this issue and notes that in the past, Transco has raised and implemented modification proposals at short notice when it has believed it necessary to do so within the framework for urgent Network Code modification proposals.

Ofgem notes that Transco are currently considering through Pricing Consultation 65 whether to establish a fund to finance Transco's buy-back actions prior to the winter auctions in the event that the auctions lead to an over-recovery against target revenue. Without prejudice to the outcome of this pricing consultation, Ofgem considers that the issue of creating a buy-back fund is worthy of exploration by Transco and industry participants. In particular, Ofgem believes that a fund of this nature may mitigate many of the concerns expressed by some respondents and Transco about the potential increased risk and associated costs of buy-back.

In summary, Ofgem considers that any artificial restriction of the release of capacity in the monthly auctions which does not accurately reflect the actual physical capabilities of the NTS may influence bidders' perceptions of the risk of constraints and scarcity and could have the effect of artificially driving up entry capacity prices. Ofgem therefore continues to support monthly capacity release based on a proportion of the maximum physical capacity of each entry terminal.

Of the modification proposals raised, Ofgem believes that the proposal (modification 0481) to sell a proportion of maximum physical capacity, best facilitates the achievement of the relevant objectives of ensuring the efficient and economic operation of the pipeline system and the securing of effective competition between relevant shippers and relevant suppliers.

In particular, Ofgem considers that Modification proposal 0481 will better facilitate the efficient operation of Transco's NTS by ensuring that capacity allocated following the monthly auction better reflects the physical capabilities of the NTS. The proposal should also ensure the economic and efficient operation of the pipeline system by identifying the true location of system constraints through the secondary and buy-markets and by encouraging Transco to discover its ability to manage the costs of a particular constraint through taking buy-back actions at different terminals.

Furthermore this modification proposal on implementation should better facilitate the securing of effective competition by ensuring that prices at different terminals reflect actual demand and supply at different locations and are not the result of artificial scarcity or surplus created by an artificial allocation of capacity to terminals based on historic flows.

Ofgem's Decision

Ofgem has therefore decided to direct Transco to implement Modification 0481, as of the four modifications raised, it would better facilitate the relevant objectives for the reasons already outlined above.

As such Ofgem considers that the proposal better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Gas Transporter's licence.

Of gem has therefore decided not direct Transco to implement modifications 0477, 0480 and 0483.

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

[4] Ofgem general letter to shippers of 17 October 2000