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Direct Dial: 020-7901 7327

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Our Ref: Net/Cod/Mod/O494

Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0494 'Amendment to the Capacity Neutrality Arrangements'

Ofgem has carefully considered the issues raised in Modification Proposal 0494 *'Amendment* to *the Capacity Neutrality Arrangements'.* Ofgem has decided to direct Transco not to implement the modification because we do not believe that this proposal better facilitates 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 entry capacity to the National Transmission System (NTS). The auctions provided for the allocation of 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, February 2001 and August 2001.

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. Subsequently, in March 2001 and September 2001, further series of MISEC auctions were conducted following the MSEC auctions

As well as capacity rights released in the monthly 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 the event of a constraint at an entry point (when physically available capacity is less than capacity sold against which gas is flowing) Transco Can buy-back capacity until the constraint is relieved.

Transco incentives and capacity revenue neutrality

Transco has financial incentives set out in the Network Code that are designed to ensure that Transco releases all capacity physically available to the market by selling additional capacity day-ahead and within-day. The incentives were also designed to provide Transco with commercial incentives to manage the costs of entry capacity constraints. Under the incentive arrangements, Transco receives 20 per cent of any revenue accruing from daily capacity sales and is exposed to 20 per cent of the cost~ of any buy-backs in the event of a constraint. In addition the incentive framework provided that Transco's potential profits and losses were capped at £5m on annual basis and divided into equal monthly caps.
Under this regime, holders of MSEC across all terminals are exposed to 80 per cent 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) received 80 per cent of the revenues associated with sales of daily capacity at these individual ASEPs.

Following Ofgem's acceptance on 9 August 2001 of Modification Proposal 0481 *'Release* of *ASEP maximum system* entry *capacity volumes for MSEC Auction',* the volumes of capacity released in the MSEC auctions held in August 2001 were significantly higher than those released in previous monthly auctions. Specifically, the amounts of MSEC offered for each ASEP in the August 2001 auctions were the highest of the monthly ASEP Maximum System Entry Capacities.

In accepting this Modification Proposal, Ofgem reiterated its preference for a capacity release 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.

Ofgem recognised that the increased volumes of capacity released in the monthly auctions following implementation of Modification 0481 would change the balance of risk and reward under the existing capacity incentive regime. Ofgem therefore accepted Transco's revised: Modification Proposal 0488, *'Redesign* of *Capacity Incentive. Regime',* under which Transco faces a monthly buy-back incentive target of £60 million over the six months or £10 million each month. In the event that actual buy-back costs are less than this target, Transco retains 8.3 per cent of the difference, subject to the existing annual cap of £5 million and a monthly cap of £416,000. In the event that actual buy-back costs are greater than this target, Transco bears 6.7 per cent of the difference, subject to the existing annual collar of £5 million and a monthly collar of £416,000.

Under the revised incentive framework any buy-back costs not paid by Transco under its incentive are smeared back to MSEC holders.

Monthly auction revenue rebalancing mechanisms

Under its charging methodology Transco seeks to recover around 5% of its allowed revenue (target revenue) under its transportation price control from the sale of entry capacity. Any deviations from target revenue are addressed through revenue rebalancing mechanisms established under Transco's charging methodology.

The deviations from target revenue that occurred during the August 2000 and February 2001 auctions were addressed through a revenue rebalancing mechanism established by Pricing Consultation 60, *'Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions'.* Under PC60, Transco addressed any under or over-recovery of revenue within a dead-band of 10% through the 'K' adjustment factor. Any under or over-recovery in excess of this dead-band was addressed through adjustments to NTS commodity charges. This adjustment was subject to the constraint that the NTS commodity charge are not set below Transco's estimate of the short run avoidable costs of operating the NTS (O.OO22p/kWh). Any over-recovery remaining due to the minimum level of NTS commodity charge results in a further adjustment to the general level of transportation charges.

Following Ofgem's acceptance of Modification proposal 481, it was recognised that a release of MSEC based on maximum physical capacity or a proportion thereof may increase the probability of buy-back actions if the NTS is constrained this winter. In this context Transco raised PC65, *'Alternative Method* of *Funding Entry Capacity Constraint Management'.*

Under PC65, excess revenue is used to rebate entry capacity charges to MSEC holders in the event that buy-back costs are incurred. Provided that auction revenue is more than ten per cent above the target level, Transco will calculate the level of this excess revenue. The excess revenue is divided into six equal monthly amounts. If monthly aggregate buy-backs costs incurred by Transco are less than the monthly amount, shippers receive a rebate that will fully offset their exposure to a share of buy back costs under the capacity neutrality mechanism.

Any over-recovery not rebated in this manner (for example, if no buy-back costs are incurred). is rolled in to the next month's fund. If at the end of the six months, a proportion of the excess revenue has not been rebated, it will be reflected in the general level of transportation. charges, as under the existing methodology

If monthly aggregate buy-backs costs incurred by Transco are greater than the monthly amount, shippers receive a rebate that will partially offset their exposure to a share of buy back costs under the capacity neutrality mechanism. Shipper's rebates are determined by their share of total MSEC holdings.

Ofgem decided not to veto PC65 indicating that it supports the principle that in the event of an over-recovery any excess revenue should be used to offset MSEC holders' exposure to that proportion of buy-back costs not paid by Transco under its incentive regime.

Following Ofgem's decision not to veto PC65, Transco raised PC67 *'Technical Adjustment to PC65 Mechanism'.* PC67 proposes a technical adjustment to the mechanism introduced by PC65, such that a non-negativity condition contained within the methodology established by PC65 is removed. Currently the reduction of shipper's charges is subject to the constraint that the reduction cannot exceed the 'unadjusted entry charge'. PC67 is the subject of a separate Ofgem decision to be released today.

The proposal

Modification proposal 0494 which has been raised by Powergen proposes an adjustment to the mechanism established under PC65 by which auction over-recoveries (auction revenue in excess of target revenue), from the sale of MSEC, are used to fund capacity buy-back costs. Under the current arrangements, to be introduced from 1 October 2001, the auction over- recovery is broken down into six equal monthly amounts, with buy-back costs in excess of this monthly amount smeared across MSEC holders. The modification proposes to provide a mechanism within the Network Code to allow buy-back costs in excess of the monthly amounts to be rolled forward cumulatively to reduce the cash flow exposures for holders of MSEC.

Respondents' views

A majority of respondents supported the proposal, although some of this support was qualified. A number of the respondents who opposed the proposal nevertheless expressed some support for its objectives.

The proposer of the modification proposal clarified that if there was a shortfall in the buy-back fund at the end of the six-month period, the deficit would be recovered from shippers based on their MSEC holdings over the whole six months of the auction period. However, it sought clarification over how any excess buy-back fund would be utilised.

A number of respondents supporting the proposal believed that it would allow a better matching of buy-back costs with the excess revenue recovered from the auctions, thereby reducing the need of funding buy-backs through additional charges to MSEC holders. Some of these respondents were critical of the flat profiling of the buy-back fund across the six month period.

Some respondents also commented that the proposal lessened the chance of unused funds from an over-recovery being returned through lower transportation charges at the end of the winter period.

One respondent stated that the proposal would help ensure that the final price paid for MSEC is as close as possible to the actual price paid at the auction.

Those respondents who opposed the proposal believed that-it is inappropriate to adjust the capacity regime arrangements and rules after the monthly auctions have taken place as such changes could alter the value of the product that has been sold. Some of these respondents suggested that the implementation of this proposal would create a dangerous precedent that could undermine future capacity arrangements. One such respondent said that changes should only be made in exceptional circumstances, where the disadvantages of maintaining the rules can be clearly demonstrated to outweigh the serious damage that such changes cause to the validity of the auctions concerned and of future auction processes. This respondent did not believe that the present proposal met these criteria. In particular, it felt that approving the proposal would create a dangerous precedent and would adversely affect the willingness of parties to participate in long-term auctions.

One respondent that supported the proposal nevertheless said that, in general, ex-post policy changes were not preferable. However, it considered that it was unlikely that this proposal would have significantly affected bidding behaviour and felt that the value of capacity should not change.

One respondent that opposed the proposal indicated that it would have supported it if the change had been proposed prior to the commencement of the auctions. This respondent indicated that the buy-back fund under the proposal would have been structured in such a manner as to minimise the degree of any remaining excess at the end of the six month period.

One respondent indicated that it supported the underlying principle behind the proposal but considered that there had been insufficient time to fully think through all of its consequences This respondent also suggested an alternative proposal of profiling the over-recovery fund to better reflect the likely levels of buy-back costs. Under the alternative proposal the buy back fund would be profiled based upon. a methodology linked to the difference between. SND + 10% and the volumes offered for sale in. the August 2001 auctions.

One respondent indicated that the process for introducing changes for the winter 2001 auctions appears to have been flawed, because it did not provide sufficient time for full consideration of the impact of the changes. Another respondent indicated that there were flaws in the way in which the buy-back fund had been designed. The respondent said that this was in part due to Transco modifying the original proposal before distributing its report, thereby precluding the opportunity to comment on the revised proposal. Several respondents also expressed concerns regarding uncertainties as to how PC65 and the buy-back fund would operate in practice.

Two respondents queried whether it is procedurally possible to make changes to Transco's pricing methodology through modification of the Network Code. One such respondent felt that it was important that Ofgem and Transco provide a clear framework.. The other respondent thought that it was possible for Transco to raise a pricing consultation. to effect the proposal and suggested that Transco should raise a pricing consultation. to enable the issues to be properly debated..

Transco's view

Transco is opposed to the proposal. Transco indicated that in general it is opposed to modifications that change the contractual rules for entry capacity after the auctions for MSEC have been conducted.

Transco also comment that any changes to the buy-back fund arrangements should be introduced via a pricing consultation rather than via changes to the Network Code.

Transco noted that as constraint management costs are difficult to predict a flat profile over the period could be considered as valid as any other methodology. Transco stated that the equal spread of over-recovery across the six months, as provided for in PC65, could be considered as valid as any other methodology, given that constraint management costs are difficult to predict.

Transco also indicate that spreading any excess uniformly over the period reduces possible distribution effects between users with different capacity profiles.

Ofgem's view

Ofgem continues to believe that an enduring solution to addressing any future over or under-recoveries associated with MSEC auctions is needed for the period beginning April 2002, as part of the process of developing the framework for long-term investment in the NTS. Ofgem therefore encourages Transco to facilitate discussion of this issue with the industry and other interested parties.

Ofgem is also supportive, as many respondents were, with the principles underlying the proposal and its intent. In particular, Ofgem believes there is considerable merit, in designing future methodologies to deal with over and under recoveries, in seeking to use methodologies such as the one proposed to address uncertainties about the profile of buy back costs across the winter. Ofgem also supports the principle that any proposed methodology should seek to ensure that the general level of transportation charges is adjusted only if the over-recovery exceeds buy-back costs over the relevant charging period.

Ofgem notes, however, the concerns raised by many respondents about making material changes to the buy-back fund mechanism after the auctions have been completed. Ofgem, in taking its decision not to veto PC67 which made a technical amendment to the buy back fund's operation, was satisfied that the change was minor and technical in nature and consistent with the intent of the original proposal to establish the buy-back fund.

Ofgem does not believe that this is true of this modification proposal, which clearly seeks to change the operation. of the buy-back fund in a way that participants would not have anticipated when entering the auctions. Ofgem therefore accepts the arguments raised by a number of respondents that although the proposal has merits, it would be inappropriate to make material changes to the operation of the buy back fund after the auctions have been completed. Ofgem accepts that if the modification were implemented, it might alter the valuations that shippers place on MSEC capacity. Ofgem does not believe that the issues that this modification proposal seeks to address are such as to overcome the general presumption against Network Code amendments that have retrospective effects.

Ofgem notes the concerns of a number of respondents about the process leading up to the recently completed auctions. Of gem shares respondents concerns about the number of changes to the arrangements that were proposed and implemented shortly before the auctions were held. As indicated in our decision with respect to PC65, Ofgem would also urge Transco and shippers in future to try to ensure that proposed amendments to its pricing methodology are conducted in a timely manner well before the auctions are due to commence.

Ofgem therefore believes that the proposal would not better facilitate the relevant objectives of the Network Code. In particular, Ofgem believes that the proposal to effectively introduce changes to the operation of the buy back fund by altering the way in which capacity revenue neutrality is charged back to shippers after the auctions were held would not better facilitate the securing of effective competition between relevant shippers.

Ofgem's decision

Ofgem has decided not to consent to this modification, as we do not believe that it will better facilitate the achievement of the relevant objectives as outlined under Standard Condition 7 of the Network Code.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Mark Feather on 020 7901 7437.

Yours sincerely,

Steve Smith
Director, Trading Arrangements