Direct Dial: 020-7901 7327

24 August 2001

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/490, 490a

Dear Colleague,

Modification Proposals 0490 'Adjustment to ASEP Capacity Revenue Neutrality calculation' and 0490a 'Adjustment to ASEP Capacity Revenue Neutrality calculation – Transco alternative'

Ofgem has carefully considered the issues raised in Modification Proposals 0490 '*Adjustment to ASEP Capacity Revenue Neutrality calculation'* and 0490a '*Adjustment to ASEP Capacity Revenue Neutrality calculation – Transco alternative'*. Ofgem has decided to direct Transco not to implement the modification because we do not believe that either 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 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 releasing MSEC, Transco also makes available Monthly Interruptible System Entry Capacity (MISEC) rights.[1] The next series of auctions are scheduled to commence on 29 August 2001 for the six months 1 October 2001 to 31 March 2002.

[1] MISEC rights were introduced following Ofgem's acceptance of Modification Proposal 0410 *'Auctions of Monthly Interruptible System Entry Capacity'*.

As well as capacity rights released in the monthly auctions, Transco releases on a daily basis firm and interruptible capacity where there is additional capacity physically available. A within-day capacity market became operational on 1 June 2000.

In the event of a constraint at an entry point (when physical capacity available is less than the capacity sold against which gas is flowing) Transco can buy back entry capacity rights.

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. Under this regime, Transco retains 20 per cent of any additional revenue associated with the sale of daily firm and interruptible capacity. Conversely, Transco is liable for 20 per cent of the costs of buying back capacity in the event of a constraint. Transco's risks and rewards under the scheme are subject to an annual cap and collar of £5 million, which is divided into equal monthly limits.

Under the daily capacity regime, holders of MSEC capacity across all terminals bear 80% of the costs of capacity buy-backs in proportion to their holdings of capacity; whereas 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. In addition, if Transco reaches its monthly cap or collar, any additional revenues or costs are entirely passed onto shippers in accordance with the above mechanism.

Following Ofgem's acceptance of Modification Proposal 0481 '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*', the volumes of capacity to be released in the forthcoming winter auctions are significantly higher than that released in previous auctions. Specifically, the release of MSEC quantities for each ASEP for each month will be equivalent to the highest of the monthly ASEP Maximum System Entry Capacities. In accepting this proposal, Ofgem recognised that the balance of risk and reward under the current capacity incentive regime may be affected and that an adjustment to Transco's capacity incentive may therefore be appropriate. Accordingly, Transco raised Modification Proposal 0488 *'Redesign of the Capacity Incentive Regime'* on 16 August 2001, which proposed that the current capacity incentives be disabled and replaced with a new incentive regime, based on variance of performance from target. Ofgem's decision on modification proposal 0488 has been released today.

On 30 July 2001 Transco issued Pricing Consultation 65, '*Capacity Auction Revenue Redistribution Mechanism*'. This paper proposes an amendment to the existing auction over and under-recovery mechanism. The proposal provides for auction over-recoveries to be diverted into a fund that is to be used to offset the costs of daily entry capacity buy-backs undertaken by Transco during periods of system constraints. Transco has recently completed a consultation on this proposal. The proposal forms the subject of a separate decision letter that has been released today.

Modification Proposal 0490 ***'Adjustment to ASEP Capacity Revenue Neutrality calculation'***

This modification proposal which has been raised by BG Gas Services provides for a re-apportionment of the costs of daily capacity buy-backs to shippers. Rather than being allocated to all MSEC holders in proportion to their holdings of capacity, costs would be allocated as follows:

- 50 per cent to holders of 'Effective Capacity Entitlements' at the constrained ASEP(s); and
- 50 per cent apportioned across all MSEC holders (as at present).

'Effective Capacity Entitlements' would include MSEC, MISEC, 'effective' Day-Ahead Interruptible (DAI) and Within-Day Firm (WDF) entry capacity.

These costs would be targeted to shippers holding the effective capacity on a day, rather than the initial relevant holder of capacity calculated on a monthly basis.

The apportionment of any incremental daily capacity sales revenues would not be affected.

The proposal is independent of whether Modification Proposal 0488 *'Redesign of the Capacity Incentive Regime'* is accepted. If this proposal were implemented within the scope of the existing incentive regime, the split of costs would be 20 per cent to Transco, 40 per cent to shippers at constrained ASEPs and 40 per cent to all MSEC holders.

Modification Proposal 0490a ***'Adjustment to ASEP Capacity Revenue Neutrality calculation – Transco Alternative'***

In response to BG Gas Services' Modification Proposal *0490 'Adjustment to ASEP Capacity Revenue Neutrality calculation'*, Transco has raised an alternative modification proposal, in order to clarify the basis for 'Effective Capacity Entitlement' at an ASEP level. Transco alternative proposes a similar driver for the apportionment of costs across all ASEPs.

Under this proposal, which is also independent of the result of Modification Proposal 0488, capacity surrender costs would be borne by shippers on the following basis:

- 50 per cent to shippers with 'Effective Capacity Entitlements' at the constrained ASEP(s) ('Effective Capacity Entitlement' is defined as MSEC, MISEC, effective DAI and WDF entry capacity, adjusted for accepted buy-back bids and shipper to shipper trades); and
- 50 per cent in proportion to shippers 'Effective Entitlements' at all ASEPs.

These costs would be targeted to Users holding the effective capacity on a Day, rather than the initial relevant User of the capacity.

Transco has made clear that the raising of the alternative proposal should not be taken as an indication of Transco's support for the concept, nor for making any modification to the auction arrangements at short notice.

Respondents' views

A clear majority of respondents opposed the modification proposals. Of those supporting the proposals, a majority supported Modification Proposal 0490a over 490.

Most of the respondents opposed to the proposals indicated that there was not sufficient time to properly assess the implications of the proposals. One such respondent, nevertheless, had some sympathy with the proposals and the principles it sought to address. However, it submitted that more time was needed to debate the proposals. Several other respondents also suggested that the proposals needed further industry discussion.

One respondent suggested that continued delays and uncertainty associated with the raising of modification proposals at such a late stage creates volatility and may produce corrections in the forward curve. Another respondent suggested that the lack of time to digest the implications of the proposals add to uncertainty with bidding strategies.

Some respondents expressed disappointment that, given that these modifications were raised as a consequence of Modification Proposal 0481 '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*', the modifications were raised almost two weeks after Ofgem's acceptance of Modification Proposal 0481.

A number of respondents opposing the proposals indicated that it is not clear whether a system constraint can be attributed to a particular terminal due to the integrated nature of the NTS. As such, these respondents queried whether a constraint could simply be defined with respect to where a buy-back has occurred and suggested that it is therefore more appropriate to apportion the costs of buy-backs across all MSEC holders.

In this context one respondent suggested that it could be that a cost minimising approach of relieving constraints at St Fergus would be for Transco to buy-back capacity at Teeside or Barrow. This respondent then questioned whether the Teeside and Barrow terminals would be considered to be constrained in these circumstances such that a proportion of the costs of buy-back would be shared with shippers at the St Fergus terminal.

One respondent opposed to the proposal indicated that there is some uncertainty over the degree to which the sale of additional quantities of capacity will lead to higher buy-back costs this winter. This respondent suggested that as more capacity is offered for sale the buy-back market should be more liquid and lower prices should result.

Another respondent opposed to the proposals indicated that the effect of the proposals would be to incentivise shippers to minimise their capacity holdings obtained in the auctions to the extent that system security could be impacted. This respondent indicated that any resulting ‘primary rationing’ could have impacts on the price of gas as Transco would have control and discretion over where shippers land their gas on the system.

Of those respondents supporting the proposals, a majority favoured Modification Proposal 0490a over 0490. One such respondent said that 0490a was clearer on the issue of capacity entitlement and supported the modification on the basis that it apportions capacity costs across all types of capacity holdings and not simply MSEC holders across terminals. Another respondent expressed its preference for modification 0490 indicating that any smear back of buy-back costs at non-constrained terminals should take place according to MSEC holdings only. One respondent indicated that proposal 490a provides a better focus of costs on capacity holders at constrained terminals.

One respondent supporting the proposals said that the current system of apportioning buy-back costs was flawed because it spread the costs across all ASEPS, including those which could have no possible impact on the constraint. This respondent, while acknowledging that the Network Code defines a constraint at a system level rather than at the ASEP level and that there may be some substitutability between ASEPs, nevertheless said that holders of capacity at the constrained ASEP(s) have the ability to mitigate their position and earn revenue substantially above the cost of the capacity, albeit at the expense of deferred production.

A number of shippers in support of modification proposal 0490a suggested that it would reduce the level of cross subsidy from holders of capacity at non-constrained terminals to holders of capacity at constrained terminals.

Transco's view

Whilst sympathetic to the concerns arising from the timing of the modification proposal, Transco considered that this does not of itself constitute a reason to reject it.

Transco believes that modification proposal 490a will better promote cost targeting and hence would improve the operation the regime without increasing its complexity or administration.

In addition, Transco considers that the adoption of the proposal will generate greater competition in the buy-back market where it will provide shippers holding unwanted capacity with stronger incentives to sell it back to Transco thereby avoiding a share of capacity buy-back costs that it would otherwise face under the current arrangements.

Transco recognises that there is no analytical basis to the proposed 50/50 split that has been proposed but nevertheless considers that it is directionally appropriate. Transco notes that there is a risk of buy-back cost apportionment within the currently defined regime that generates costs at terminals that are themselves not likely to be subject to significant levels of buy-back activity. Transco notes that implementation of modification proposal 0490a will reduce this commercial impact.

Ofgem's View

Ofgem supports the view, as a general principle, that costs should be targeted back to those participants that cause them to incurred.

However, Ofgem also recognises the concerns raised by a large number of participants that constraints can occur on a system wide basis, particularly given the inter-terminal substitutability that exists on Transco's NTS. In this context Ofgem is not convinced that it is necessarily appropriate to target the costs of buy-backs at the terminals where the buy-backs have occurred. In this regard Ofgem agrees that the proposals may not more effectively target the costs of buy-backs.

Ofgem believes that these proposals raise important issues which merit further consideration prior to future rounds of auctions of monthly entry capacity. Such an approach would allow more detailed consideration of the objective of better cost targeting and the best approach to achieve this objective, with the benefit of better information about the nature of inter-terminal substitutability in the NTS.

As Transco itself acknowledges, there is no analytical basis for supporting the proposed 50/50 split contained within either modification. As a result of this and the limited time given to respondents to consider the proposal, Ofgem is not persuaded that either proposal would better facilitate the relevant objectives of Transco's Network Code. As we cannot be certain, on the basis of Transco's and other respondents' views that implementing either proposal would lead to more accurate cost targeting we are not persuaded that either proposal would better facilitate the relevant objectives of the efficient and economic operation of the pipeline system and/or the securing of effective competition between relevant shippers and suppliers.

Ofgem's Decision

Ofgem is not convinced that either proposal better facilitates the efficient and economic operation of the NTS. The present uncertainty in the actual inter-terminal substitutability means that it is not clear that it is possible to effectively target the costs of a system constraint to the cause of such a constraint. This uncertainty also leads to uncertainty in the definition of a 'constrained terminal'. With such uncertainty, we are unable to say that implementation of either proposal would improve the efficient and economic operation of the NTS.

Accordingly, Ofgem has decided not to consent to these modifications, as we do not believe that they better facilitate 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 or Mark Feather on 020 7901 7437.

Yours sincerely

Steve Smith
Director, Trading Arrangements