Direct Dial: 020 7901 7437

5 February 2002

Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/478

Dear Colleague,

Modification Proposal 478: Re-instating interruptible capacity within day

Ofgem has considered the issues raised in Modification Proposal 0478: '*Re-instating interruptible capacity within-day'.* Ofgem has decided to direct Transco not to implement the modification, because we do not believe that the proposal will better facilitate the achievement of the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give our 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 six month auctions were held in March 2000, August 2000, February 2001 and August 2001.

In addition to releasing MSEC, Transco also releases firm capacity on a daily basis. A within day capacity market has operated since June 2000. Transco is required to buy this capacity back from shippers to the extent that it is unable to deliver against the firm capacity it has sold.

Transco has also conducted Monthly Interruptible System Entry Capacity (MISEC) auctions. The first of these auctions was held in November 2000 for the period December 2000 to March 2001. Subsequent MISEC auctions have occurred for the periods April 2001 to September 2001 and October 2001 to March 2002. The introduction of the MISEC product followed Ofgem's acceptance of Modification Proposal 0410, '*Auction of Monthly Interruptible System Entry Capacity'*. Modification 410 provided for the release of entry capacity at maximum physical levels through a combination of MSEC and MISEC auctions.

The MISEC product has now been withdrawn following Ofgem's acceptance of modification proposal 499, '*Transition Arrangements for Long Term Capacity Allocation'.* Ofgem accepted this modification proposal on the basis that Transco is to offer firm capacity volumes at close to maximum physical levels in the forthcoming February 2002 entry capacity auctions for the period April to September 2002.

Notwithstanding the withdrawal of the MISEC product, under the existing regime, Transco will continue to offer use-it-or-lose-it interruptible capacity in the daily capacity auctions. This product is released as an anti-hoarding product.

Interruptible capacity is intended as a tool to allow shippers to manage daily uncertainty regarding their capacity requirements. However it does carry a higher risk of curtailment than firm capacity. If Transco cannot make interruptible capacity available it is permitted to curtail the capacity without bearing any liabilities. By contrast, firm capacity holders are compensated for any loss of capacity through the buy-back mechanism.

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.

In August 2001 Ofgem accepted Modification proposal 488, '*Redesign of Capacity Incentive Regime'*. This proposal was raised following Ofgem's acceptance of modification 0481, *'Release of ASEP maximum system entry capacity volumes for MSEC Auction'* that provided for the release of increased capacity volumes during the winter 2001/2 MSEC auctions. The release of these additional quantities substantially altered the risk and reward profile under Transco's existing incentive by significantly increasing the probability of buy-back and conversely reducing the probability of daily capacity sales.

Under the incentive, Transco is set a target of buy-back costs for the winter months of £60m. Under the scheme, Transco retains a proportion of any savings if buy-back costs are below the target and pays a proportion if buy-back costs are above the target. Transco's annual exposure under the scheme remains at £5m. The incentive is intended to apply until 31 March 2002.

Under Ofgem's final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 Transco will continue to be provided with a target based buy-back incentive. Under Ofgem's proposals, which Transco has accepted in principle, Transco will be set a 2 year buy-back incentive. Transco's exposure under the new incentive regime has been increased compared with the existing regime.

Gas balancing

In its February 2001 consultation on the reform of the gas balancing regime, Ofgem highlighted a number of significant concerns associated with the within-day profiling of gas inputs onto the NTS and the direct and indirect costs associated with this behaviour. In particular, Ofgem raised concerns that within-day profiling was contributing to volatility in prompt prices (which could feed into forward prices) and significantly increases the operational risks that Transco faces in its role as system balancer. Ofgem also considered that these problems were likely to increase over time and extend to offtake profiling as owners of gas-fired generation plants seek to respond to the new price signals emerging under NETA within-day.

In response to these concerns Ofgem proposed fundamental reforms to the existing balancing regime including the introduction of shorter balancing periods combined with a linepack service.

Ofgem has completed its gas balancing consultation and expects to be in a position to release its conclusions on the reform of the gas balancing regime shortly.

Since the release of Ofgem's February 2001 consultation, Transco has continued to experience within-day profiling on the NTS. In order to address these concerns Transco has raised Modification proposal, 0512, '*Introduction of a within-day entry profiling charge'*, which would pass the costs of any within-day 'system balancing' actions taken by Transco to those shippers shipping through sub-terminals where input profiling of gas within-day has occurred. Transco would separately distinguish within day 'system balancing' costs, required for operational purposes, from end of day 'energy balancing' costs, required to maintain end of day balance. The purpose of the proposal is to provide incentives on shippers to flow gas in accordance with their uniform flow rate obligations across the gas day and to better target the costs associated with profiling at terminals.

Scale back of interruptible capacity

Throughout 2001 several shippers have raised concerns regarding the scale back of interruptible capacity by Transco early in the gas day when later in the day it has become apparent that this was no longer necessary. Transco has indicated that the scale back of interruptible capacity has occurred often as a result of the within-day flow variations it has been experiencing on the NTS and the impact that these flows have on the ability of Transco to make the capacity it has sold physically available on the gas day.

Accordingly a modification proposal has been raised to enable Transco to reinstate interruptible capacity within day when it becomes apparent that spare capacity is available.

The modification proposal

It is proposed that where interruptible entry capacity is curtailed, Transco would be allowed subsequently to adjust the curtailment factor back up during the gas day when it becomes apparent that there is spare capacity available. Under the proposal, notice would be provided by a 'restoration of interruptible capacity notice' giving the new interruptible curtailment factor.

Respondents' views

Three representations were received in response to the modification proposal. Of the responses two respondents supported the proposal and one respondent opposed its implementation.

Of the two respondents who supported the proposal one respondent argued that reinstating capacity during the day would prevent shippers having to buy additional firm capacity unnecessarily which would place less pressure on firm capacity prices and would maintain price stability. The other respondent believed that Transco has been using interruptible capacity curtailment for commercial gain in order to sell additional firm capacity to the market. The respondent indicated that the scaling back of capacity should be primarily driven by commercial considerations, such as the likelihood of constraints, rather than Transco commercial gain. The respondent stated that the modification proposal should be amended such that Transco would not be permitted to sell daily firm capacity during any period of the day during which a scale back factor applies. The effect of this would be to require Transco to reinstate interruptible capacity when there is capacity available. This respondent also queried Transco's assertions that the proposal would lead to costly and complex systems and operational changes.

The respondent who did not support the proposal commented it would undermine the value of the firm capacity service. The respondent commented that its implementation could introduce further uncertainty if interruptible capacity is brought on and off line during the day depending on changes to the flow of gas. The respondent states that the concern raised by the proposal regarding the availability of capacity should instead be addressed through sales of firm capacity or the development of an efficient and transparent secondary market.

Transco's view

Transco is opposed to the proposal on the basis that it is inconsistent with the objective of promoting firm capacity rights. It argues that the proposal would make the interruptible capacity product increasingly similar in terms of certainty to firm capacity and effectively seeks to change the relationship between firm and interruptible capacity. Transco notes that the proposal would lead to different treatment between buy-back actions and interruptible capacity curtailment. Currently once a buy-back action is taken for firm capacity these capacity rights are lost to the shipper for the gas day. Furthermore, Transco has indicated that the proposal would require additional monitoring of interruptible capacity within the day with its availability being managed in a similar manner, when firm capacity is managed on an end of day basis. Transco states that the cost of this would be significant in comparison to the benefits since it believes that there would be few opportunities to reinstate scaled back interruptible capacity.

In particular, Transco has noted that the systems changes to support this modification proposal would involve complex reprogramming in respect of introducing functionality to manage 'upwardly adjusting' interruptible curtailment factors when currently the system is 'hardcoded' to facilitate the scaling of capacity only in one direction.

In addition, Transco has indicated in Network Code workstream forums that the current interruptible capacity product is providing some shippers with regular access to cheap capacity, frustrating the efficient operation of the secondary capacity market rather than delivering an effective anti-hoarding device. In this respect, Transco has provided analysis to show that secondary trading of firm capacity is much higher on days when interruptible capacity is scaled back than when it is not.

Transco has also indicated that given the levels of interruptible capacity released to the market and uncertainties concerning the extent to which shippers flow against this capacity make interruptible scale back decisions difficult. Transco has indicated that these uncertainties would also present problems in determining how much capacity should be reinstated.

Ofgem's view

Ofgem has carefully considered the merits of this proposal and the views expressed by Transco and respondents.

Ofgem recognises the operational difficulties associated with within-day gas flows that Transco is currently experiencing on the NTS. In particular, Ofgem considers that on some occasions these operational difficulties may have been caused by shippers failing to flow in a manner that is consistent with their Network Code obligations to use all reasonable endeavours to ensure that gas is delivered at uniform flow rates.

Ofgem also recognises that the failure of shippers to flow at uniform flow rates could effectively result in the curtailment of interruptible capacity as Transco is unable to make the capacity it has sold on the basis of these implied flow rates physically available during the day. In particular, Ofgem considers that under the daily balancing regime interruptible capacity holders may be curtailed as a result of the failure of other shippers to flow at uniform flow rates. Ofgem has concerns that this may undermine the usefulness of the use-it-or-lose-it interruptible product as an effective anti-hoarding product.

Whilst this proposal aims to assist in reducing the impact of within-day flow rates on curtailment of interruptible capacity, Ofgem shares the concerns expressed by Transco regarding the systems costs associated with providing Transco with a discretion to reinstate interruptible capacity. In addition, Ofgem considers that the proposal may only serve to exacerbate the within-day problems being experienced by Transco in operating the NTS.

Instead, Ofgem believes that industry participants should give consideration to developing measures that seek to improve the targeting of the costs associated with variations in within day flows against capacity holdings. This could include the development of within-day overrun charges that are determined on the basis of deemed flows at individual terminals where shippers hold capacity with each shippers end of day capacity rights being divided into equal hourly units. Ofgem notes that discussions are currently occurring within the RGTA Workstream forum regarding dividing the end of day capacity product into hourly units

Ofgem also notes the concerns raised by Transco during Workstream discussions regarding the level of interruptible capacity offered to market and Transco's analysis of the relationship between interruptible capacity curtailment and secondary trading of capacity. Ofgem does not accept that the release of interruptible capacity to the market undermines secondary trading in firm capacity. Ofgem accepts that the volumes of firm capacity that are traded may rise during periods when interruptible capacity is also being curtailed. However, we would expect the value of capacity to be higher and the volumes of secondary trading to increase during periods where as a result of constraints, Transco is unable to make the capacity it has sold physically available on the day. In addition, we do not accept that the existence of a use-it-or-lose-it daily interruptible product would have a significant impact upon the price of firm capacity. The use-it-or-lose-it product should only have value if there is capacity hoarding and should therefore serve to encourage the secondary trading of firm capacity rights.

Ofgem's decision

Ofgem considers that the implementation of this proposal is likely to result in Transco incurring significant systems costs with limited benefits. In this respect, Ofgem does not believe that the proposal would better facilitate the efficient and economic operation of the NTS.

Accordingly, 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 9 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.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements