Direct Dial: 020-7901 7327
17 September 2001

Transco, Shippers and Other Interested Parties

Your Ref:
Our Ref : Net/Cod/Mod/0491

Dear Colleague,

Modification Proposal 0491 'Introduction of a "potential Buy Back" notification and discrete window for Buy Back activity'

Ofgem has carefully considered the issues raised in Modification Proposal 0491 *'Introduction of a "potential Buy Back" notification and discrete window for Buy Back activity'*. 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.

Following Ofgem's acceptance of Modification Proposal 0432, *'Definite Gate Closure Times for Daily System Entry Capacity Bids'*, there is a gate closure time before which bids for daily system entry capacity must be submitted if they are to be considered in a subsequent allocation process. This proposal was designed to address shipper uncertainty as to when Transco would commence an allocation of capacity bids, which was potentially contributing to bidding errors.

In the event of a capacity constraint, Transco can scale back interruptible rights and it can buy back firm rights. Capacity buy-backs are conducted via the RGTA capacity screens, by Transco accepting bids placed by shippers offering to sell their capacity rights. Currently, there is no provision for Transco to place offers to buy back capacity, thereby signalling the price at which it would be willing to buy back capacity at particular terminals.

At the same time as the auctions were introduced, Modification Proposal 0314, *'Development of Entry Capacity Entitlements Based on an SND Profile'* placed new commercial incentives on Transco relating to its actions in the daily capacity markets. These new incentives were designed to ensure that Transco released all capacity physically available to the market through a combination of the monthly and daily auctions. The incentives were also designed to provide Transco with commercial incentives to manage the costs of entry capacity constraints. Under the new arrangements, Transco received 20 per cent of any revenue accruing from daily capacity sales and was exposed to 20 per cent of the costs of any buy backs. Under the incentives, Transco's potential profits and losses were capped at £5m.

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 previous releases. Specifically, the amount of MSEC offered for each Aggregate System Entry Point (ASEP) in the August 2001 auctions was 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. The adjustment is intended to ensure that the changes leave Transco with broadly the same incentive, given the change in risk and reward associated with releasing more capacity.

At the same time as the capacity incentives were introduced, new commercial incentives on Transco were introduced in relation to its role as residual gas balancer. Shippers face commercial incentives under the Network Code to balance their own offtakes and inputs to the system each day. Transco is responsible for the residual balancing of the NTS from day to day to the extent that aggregate inputs and offtakes do not match. Transco currently undertakes its role as residual gas balancer by buying and selling gas on the On-the-day Commodity Market (OCM)[1]. Under the incentives, which are designed to ensure that Transco carries out its role efficiently, the price of Transco's actions are compared to the price of trades in the market. If Transco trades close to average market prices, it could receive a bonus payment of up to £4,000 per day. If it trades away from market prices, it pays a penalty of up to £30,000 per day. Transco's potential profits and losses under the scheme are capped at £2m.[2] In June 2001, a linepack target was included in the incentive scheme. This was to avoid any perverse incentives under the arrangements to carry over system imbalances from day to day.

In relation to its role as residual gas balancer, Transco conducted a signalling trial from 19 October 1999 to 11 April 2000. It indicated to the market via AT Link and the OCM screen whether it was likely to buy, sell or remain neutral. It was argued that such signalling would bring more depth and price competition to the market as traders re-priced in response to the signal. However, competitive re-pricing was limited. In addition, there were concerns that the signalling was distorting behaviour

[1] Since October 2000, Transco has not been obliged to trade exclusively on the OCM.

[2] The price incentive was changed by Modification Proposal 0414, *'Proposal to reform the Transco energy incentive – redesign'*, which facilitated the introduction of the linepack incentive. Prior to the implementation of this modification, the potential bonus Transco could earn was limited to £2,000 per day and its potential penalty was limited to £15,000 per day.

on the OCM. Transco commented that it did not see any marked change in market liquidity following the trial's suspension.

At the time of the introduction of the new incentives, significant revisions were made to Transco's Operational Guidelines (OGs). The OGs set out the principles and procedures Transco follows when seeking to manage and balance the system from day to day. Prior to October 1999, the OGs had contained prescriptive rules that determined Transco's actions when seeking to balance the system. In following the OGs, Transco had limited discretion over the timing of its balancing actions. Shippers, Ofgem and customers had expressed considerable concern about the effects of Transco being obliged to follow the OGs. Ofgem argued that the limited discretion afforded to Transco was leading to inefficient balancing actions and higher costs. On a number of occasions, Transco had incurred very high balancing costs and set very high cash out prices as a result of small volume actions taken in accordance with the OGs.

Consistent with the new commercial incentives, Ofgem approved a number of modifications to the OGs. Transco was given considerable discretion over the timing and size of any balancing actions within the new incentive framework.

The proposal

The proposal provides that, in the event of Transco determining there to be a likelihood of the need for buy-backs, Transco be required to signal this possibility to shippers via an ANS message. It further proposes that following such notification, Transco would be required to conduct and complete its buy-back activity during the first fifteen minutes of the next hour bar.

Respondents' views

Of the responses received, the majority supported the proposal on the grounds that they believed it would encourage active shipper participation and market liquidity in the buy-back market thereby lowering buy-back costs. They also argued that it would facilitate more efficient use of operational resources.

One respondent, although finding merit in the proposal, raised several queries about the practical operation of the proposal. The respondent assumed that shippers would remain free to post buy-back offers at any time. However, it expressed concern that the potentially increased number of shippers seeking to post offers within a reasonably limited timeframe may have an adverse impact on Transco's system. In addition, the respondent was unsure whether or not Transco would be required to indicate in any notification the volume of buy-backs it sought. Another respondent stated that it would not necessarily expect Transco to fulfil all of its buy-back requirements within one fifteen-minute 'window'.

Two respondents suggested refinements to the modification proposal. One suggested that Transco should state in its ANS signal the probability of buy- backs occurring with an added requirement that that probability be higher than 90 per cent. This respondent expressed a concern that if shippers think that the system is constrained, this could lead to higher gas prices. Otherwise, the respondent supported the proposal on the condition that Transco does not use the ANS signal too frequently. The other respondent suggested that the buy-back window should be 20 minutes and not the proposed 15 minutes. Further, the respondent believed that a minimum notice period for the buy-back activity of 45 minutes should be introduced and the notification should be via ANS, fax and email.

One respondent opposed the proposal. This respondent believed that the proposal could adversely affect market liquidity and efficiency. The respondent highlighted that the OCM signalling trial did not improve liquidity or balancing outcomes. The respondent was of the opinion that the restriction of capacity buy- backs to a discrete window would adversely affect the market by reducing liquidity and increasing volatility. It said that liquidity would develop as Transco actually starts taking buy-back activity. Further, it suggested that shippers needed to be prepared to always place offers at a price they would be prepared to sell capacity back to Transco rather than waiting to be prompted. The respondent also doubted the ability of the RGTA computer system to accommodate the proposal.

This respondent expressed the view that it was more important that Transco should use reasonable endeavours not to take either capacity or balancing actions in the last 20 minutes or so of any hour, in order to allow shippers to make any necessary renominations by the following hour bar.

Transco's view

Transco opposed the proposal. While it agreed that the implementation of Modification Proposal 0481 *'Release of ASEP maximum system entry capacity volumes for MSEC Auction'* might increase the likelihood of capacity buy-back activity, Transco did not believe that notification and a discrete window for buy-back activity would improve the efficiency or reduce the costs of buy-backs.

Transco considered that that it should be able to undertake capacity buy-backs in a manner which it deems to be commercially or physically appropriate, consistent with its buy-back incentive and its OGs. It expressed concern that limiting the manner in which it could undertake buy-back actions would place it in the position of a 'distressed buyer', leading to higher buy-back costs.

Transco also expressed concerns about the ability of its systems to accommodate the proposal, particularly given the potentially large increase in within-day capacity trades resulting from implementation of Modification Proposal 0481 and the need to conduct regular within-day releases of capacity.

On the issue of use of resources, Transco did not accept that the proposal would lead to greater efficiency. Conversely, it said that the additional processing of buy-back data for every hour would require additional resource effort in its 24-hour control room.

While Transco did not support the proposal, it did believe that under some circumstances there might be merit in signalling its intention to buy back, but it did not believe that it should be under any contractual obligation to provide such notifications. It also agreed that actions close to the hour bar could result in shippers not having sufficient time to notify their gas producers to affect gas flows. It therefore recommended that it would normally accept buy-back offers 20 minutes before the hour bar, and notify shippers accordingly.

Ofgem's view

Shippers and customers have raised a number of concerns regarding Transco's behaviour in the buy-back market and the extent to which it may have increased the cost of constraint management. Ofgem shares many of these concerns.

In particular, Ofgem is concerned that Transco has not yet sought to develop contracts that allow it to contract ahead for capacity buy-backs. Transco currently undertakes all of its buy-back actions in the spot market on the day. Ofgem continues to believe that Transco should, consistent with its incentive schemes and discretion under those schemes, seek to develop contractual tools (such as option contracts) to try and reduce the costs of constraint management.

Ofgem also believes that Transco should seek to develop its IT systems so that it could post offers to buy capacity rather than simply accepting bids. During the period of constraints last October, Transco was able to alleviate constraints through actions at three terminals (Barrow, Teeside and St Fergus). By posting offers at different terminals, Transco could signal to shippers the extent to which constraints could be relieved through purchases at different terminals and may increase competition in the buy-back market.

Ofgem is also concerned that by relying on a small number of larger volume buy-backs, Transco may be indirectly increasing the costs of constraint management. By taking large volume actions in which a number of different price offers are accepted at one time, Transco may be limiting the ability of the market to engage in the competitive re-pricing of capacity. In particular, in failing to undertake smaller incremental buy-back actions, Transco may be missing the potential to secure capacity on which shippers place a lower value, before resorting to accepting higher offers.

Shippers have also expressed concern that Transco often takes buy-back actions very early or very late in the gas day when the market is thin and many companies only have operational staff at trading screens. As such, market liquidity and the potential for competitive bidding is reduced. Although Ofgem has some sympathy with this argument, we also recognise that there may be occasions where Transco is forced to take actions early or late in the day as a result of operational concerns. To the extent that Transco has any discretion over the timing of actions, Ofgem would expect Transco, under its incentive scheme, to buy back capacity at times when the market is more liquid.

However, Ofgem does not believe that the proposal to require Transco to signal its intention to undertake buy-backs and to restrict the timing of Transco's buy-back activity would achieve the objectives of increasing liquidity and reducing buy-back costs.

Specifically, Ofgem is mindful of the experience of Transco's signalling trial in the OCM, which brought limited competitive re-pricing or liquidity and may have lead to distortions. More generally, Ofgem continues to believe that Transco, within its incentive framework, should have discretion over the nature and timing of its buy-back actions. Ofgem is concerned that the proposal for a 15-minute window in which Transco would need to complete buy-backs may reduce liquidity rather than increase it and may not facilitate competitive re-pricing that could result from Transco undertaking incremental buy-backs in a 'continuous' market. By forcing Transco to take actions within a defined period, it may lead to higher buy-back costs than would otherwise be the case if Transco had discretion over the timing of its actions.

Ofgem is therefore not convinced that the proposal would better facilitate the relevant objectives of the network code. In particular, Ofgem believes that the proposal, in reducing Transco's discretion over the timing and nature of its buy-back actions would be likely to increase the costs of any buy-back actions. Ofgem does not believe, therefore, that this proposal would better facilitate the efficient and economic operation of the pipeline system.

Ofgem's decision

Ofgem believes that this proposal would not better promote active shipper participation and greater liquidity in the buy-back market and so would not facilitate the lowering of buy-back costs and the efficient and economic operation of Transco's system.

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 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 Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Steve Smith
Director, Trading Arrangements