

**OFGEM DECISION LETTER No. 0498**  
"Capacity Forward & Option Entry Capacity Management"  
Version 1.0

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod / 498  
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Dear Colleague,

**Modification Proposal 0498: Capacity forward and option entry capacity management**

Ofgem has considered the issues raised in Modification Proposal 0498 '*Capacity forward and option entry capacity management*'.

Transco raised this proposal on 12 November 2001. Ofgem received the final modification report on 20 March 2002.

Before proceeding to confirm the decision that Ofgem has reached in respect of this modification proposal, Ofgem considers that it is appropriate to clarify some matters surrounding the modification proposal.

Ofgem notes that several respondents raised concerns that they have been unable to give due consideration to this proposal as Ofgem has yet to publish its proposed licence modifications to Transco's Gas Transporters (GT) licence to introduce Transco's price control for the period April 2002-7 in accordance with the statutory consultation process set out in section 23 of the Gas Act 1986. Ofgem also notes that several respondents have commented that it is difficult to comment on this Network Code modification proposal without having seen Transco's proposed System Management Principles Statement and Procurement Guidelines.

Transco has indicated in its final modification report that it does not believe that discussions surrounding the nature of the proposed licence modifications that include the production of Procurement Guidelines should have an effect on this proposal. Ofgem considers this is correct and wishes to clarify the basis upon which it has assessed this proposal.

Any decision placed before the Authority under standard condition 9 (Network Code) of Transco's GT licence has to be assessed against the criteria set out therein having regard to the Authority's (and the licensee's) general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the Network Code as they exist today, not as they may be in the future as a result of a consultation process on licence modifications that has not yet commenced. There are circumstances where it may be appropriate to have regard to imminent changes to a licence or regulatory regime in order to assess whether the changes meets the relevant criteria. Here it is appropriate to note the existence of the SO Final Proposals but it is

inappropriate to make assumptions about how these could be translated into licence obligations as these have yet to be consulted upon.

However, Ofgem considers it appropriate to confirm that it does intend to publish licence modifications for statutory consultation under section 23 of the Gas Act 1986 shortly. Ofgem regrets that the licence modification proposals have not yet been consulted upon. However, the translation of the SO Final Proposals into licence changes has been a substantial undertaking.

One possible consequence of that statutory consultation process is that further changes to Transco's Network Code **may** be necessary to implement changes to Transco price control (Transmission Asset Owner (TO) and SO) for the period 2002-07. It is important to stress that nothing in this decision nor any other document precludes any signatory to the nNetwork cCode raising modifications on this or any other matter in the future.

The basis for considering whether to direct that this modification be made is set out in standard condition 9 of Transco's GT licence. Having regard to the criteria set out there and for the reasons set out in the Ofgem's views section of this letter, Ofgem has decided to direct Transco to implement this proposal.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

### **Background to the proposal**

Under the capacity arrangements set out in Transco's nNetwork cCode, Transco buys back National Transmission System (NTS) entry capacity that it has sold but cannot physically accommodate on the day. Section B2.9 of the nNetwork cCode provides for Transco to buy-back capacity on the day. Currently, Transco is unable to contract forward with shippers to buy-back capacity in anticipation of potential constraints on the NTS.

Transco currently has financial incentives that are designed to ensure that Transco efficiently manages the costs of any buy-backs by exposing it to a proportion of any buy-back costs incurred. The incentives are also designed to ensure that it releases all physically available entry capacity to market by selling additional capacity within-day.

On 28 March 2002, Ofgem accepted modification proposal 0540, *'Delay of licence and effects on capacity incentives'* to implement a revised capacity incentive from 1 April 2002. Under the incentive arrangement, Transco is subject to a Capacity Incentive Performance Measure (CIPM), which is based on the magnitude of the net cost (revenue) of actual costs of capacity buy-backs and incremental sales revenue for a month, compared to an ex ante agreed target level of buy-back costs. Under the incentive Transco has been set an annual target of £35 million. The incentive is subject to an annual cap of £30 million and a collar of £12.5 million and includes a 50% upside sharing factor and a 35% downside sharing factor.

In several documents Ofgem has indicated that Transco should develop a wider range of tools to manage entry capacity buy-backs to increase the efficiency of the market. See *'Ofgem's investigation into shipper conduct in the capacity market in October 2000, Conclusions, November 2001; Transco's National Transmission System – System Operator incentives 2002-7, Initial proposals, September 2001; Transco's National Transmission System system operator incentives 2002-7, Final proposals, December 2001*. This would reduce the reliance on the daily market where Transco may often be a distressed buyer. The development of other tools would better enable Transco to manage its and shippers' risks and costs associated with entry capacity buy-

backs. In the light of this background Transco has raised this proposal to enable it to enter forwards and options contracts for capacity management purposes.

The development of new entry capacity management tools will also require an understanding of how they will be used. Therefore, Transco has also consulted on a modification to the operation guidelines (OG25) that seeks to explain when forwards and options would be used by Transco when managing the network.

### **The modification proposal**

It is proposed that Transco be allowed to use a wider choice of tools designed to facilitate the opportunity to mitigate buy back exposure and potentially to enter into forwards and options contracts for the purposes of entry capacity management. Decisions between contracting forward and buying back capacity in the prompt market would be subject to Transco's risk management processes.

Transco has also proposed that changes in shippers holdings of entry capacity as a result of its transacting with Transco for one of more of the entry capacity management tools would be registered on the UK-link system. This is to enable accurate calculation of overrun charges and Network Code section I liabilities. A further change is also proposed to enable fees (payments to shippers) for relinquishing capacity arising from an entry capacity management transaction to be registered on capacity invoices.

Implementation of this modification proposal is intended to enable better management of entry capacity buy-backs, which may reduce the risk and cost to Transco and shippers. The modification proposal is intended to apply in respect of the period 1 April 2002 to 30 September 2002.

### **Respondents' views**

Ten representations were received in respect of this modification proposal. Although most respondents supported the principle of enabling Transco to enter into forward contracts to manage entry capacity constraints, the majority did not express a definitive view on the proposal. In particular, these shippers noted that it was difficult to evaluate the proposal as Transco's proposed Procurement Guidelines and System Management Principles Statement had not been published and in circumstances where shippers had not seen Ofgem's proposals to modify Transco's licence. These views were also shared by a number of those that opposed the proposal.

One respondent supported the proposal. This respondent indicated that the proposal could enable Transco to achieve a greater level of efficiency in entry capacity management. However, the response did note that an audit of Transco's activities should be included to enable monitoring of any efficiency gains.

Another respondent offered qualified support for the proposal as it believed that the introduction of additional commercial freedom for Transco should lead to more efficient actions and see the development of a range of competitive services. However this respondent indicated that in the absence of the proposed licence modifications, Procurement Guidelines and System Management Principles Statement, that it is difficult to make an informed decision on the proposal.

Several shippers opposed the modification proposal, although some did agree with the principle of Transco having additional tools. Some of these shippers were concerned about Financial Services Authority issues, as they did not think that the modification proposal provided sufficient clarity in the application of the *Financial Services and Markets Act 2000* (FSMA) or the role of Transco as a trader.

Other issues raised included the potential market and informational advantage that Transco may have in respect of these tools thereby increasing the potential for Transco's actions to distort market prices. One

respondent indicated that the proposal would also lead back to Transco taking a more central planning role and increased participation by the system operator in the market. This respondent also indicated that the introduction of forward contracting tools would also create unnecessary complexity. Some respondents also had concerns about how the costs associated with forward contracting will be treated.

Some respondents, opposing the proposal, commented that it would be better for Transco to consider the appropriateness of forward contracts after the long-term capacity regime is finalised.

Another respondent indicated that it supported the concept of introducing new capacity management tools as this could provide some stability in prices and reduce high spikes in buy-back costs. However, this respondent also stated it could not support the proposal in the absence of further detail as to how Transco's role as a trader would be regulated and without a full understanding of the implications of the FSMA.

### **Transco's view**

Transco considers that an increased range of capacity management tools may offer it a better opportunity for effective and efficient capacity management. In particular Transco considers that the proposal would produce a lower level of costs, more predictable capacity management costs, better management of the financial risk profile, and more efficient scheduling of maintenance. Further, Transco indicated that forward contracting should offer users a greater opportunity to re-schedule their own activities if agreements are entered into and are utilised in advance of the gas day.

Transco also stated that forward contracting may also allow more shippers to participate in the capacity management process and would therefore promote further competition between shippers. Transco believes that it would also promote the development of a forward price curve for capacity and a more liquid secondary market.

Transco sympathised with shipper views on the delays to the publication of the proposed modifications to its GT licence. However, it did not believe that discussions surrounding the nature of the Procurement Guidelines should have an effect on the modification proposal which is limited in nature and seeks to enable the use of additional capacity management tools and for network code arrangements to reflect the associated invoicing and capacity registration processes.

With regard to its role, Transco does not consider that shipper fears are well founded and believes that Transco's operational freedom will be addressed in OG25, and subsequently by the development of Procurement Guidelines and the System Management Principles Statement. Further, Transco believes that contracting forward may stimulate capacity trading.

Transco also notes that the proposals are aimed at the summer period and the development of the long-term allocation mechanism may require the development of further tools. Transco considers that the FSMA issues will be resolved via the terms and conditions for of the contracts.

### **Ofgem's views**

Ofgem notes the concerns of shippers with regard to the details of the proposed changes to Transco's GT licence and the associated documents dealing with system management and procurement guidelines. However, consideration of Transco obtaining additional tools for managing entry capacity via this modification is not dependent upon the acceptance of the proposed licence modifications. As is noted above, this modification proposal must be assessed under standard condition 9 of Transco's GT licence

against the background of the licence, Network Code and the relevant facts as they exist today not as they may be in the future as a result of a licence consultation process that has not yet commenced.

Ofgem has previously stated that it believes that Transco should have access to additional entry capacity management tools to enable it to purchase capacity ahead of the day. The availability of these tools should enable a greater number of shippers to participate and compete to sell capacity back to Transco as shippers should have greater flexibility to source alternative gas given greater lead times and notice periods.

The flexibility associated with forward contracting should also reduce the reliance on daily buy backs and reduce the likelihood of Transco approaching the market as a distressed purchaser. As such, Ofgem considers that the introduction of capacity management tools and forward contracting capability should better facilitate the efficient and economic operation of the NTS.

Ofgem also considers that this proposal better facilitates the securing of effective competition between relevant shippers and between relevant suppliers by putting in place arrangements that should enable more shippers to compete to sell back capacity to Transco.

### **Ofgem's decision**

For the reasons outlined above Ofgem has decided to consent to this modification, because we believe that it will better facilitate the achievement of the relevant objectives as outlined in Standard Condition 9 of Transco's GT 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 alternatively Adam Cooper on extension 7033.

Yours sincerely,

Mark Feather  
**Head of New Gas Trading Arrangements**