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Direct Dial: 020-7901 7327

27 June 2001

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/O465

Dear Colleague,

Modification Proposal 0465 'Amendments to the NTS Entry Capacity Auction Period.'

Ofgem has considered the issues raised in Modification Proposal 0465 *'Amendments to the NTS Entry Capacity Auction Period'*. Ofgem has decided to direct Transco to implement the modification, because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the issues raised in 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 firm entry capacity (MSEC) to the National Transmission System (NTS). The auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000). Further auctions for firm monthly entry capacity were held in March and August 2000 and in February 2001 with entry capacity again sold for a period of six months in each auction.

To date, each series of auctions has been subject to delays when compared to the original timetable agreed for holding the auctions. These delays are largely attributable to proposals that have been raised to modify the capacity regime in the period immediately prior to the commencement of the auctions.

It was originally envisaged that the third round of auctions, held in August 2000, would allocate entry capacity for a twelve-month period (1 October 2000 to 31 September 2001). In particular, it was believed that after the initial two auctions of entry capacity, participants would have acquired sufficient familiarity with the auction process to enable an extension of the NTS capacity auction period to twelve months.

However, prior to the commencement of the August 2000 auctions round, Transco raised modification 0409, *'Review to monthly auction capacity parameters'*, which proposed limiting the sale of firm monthly entry capacity to six rather than twelve months. This proposal was supported by the majority of shippers, who felt that it would have provided them with additional time to evaluate changes to the capacity regime. Ofgem accepted modification 0409, with a view to introducing longer-term auctions in subsequent entry capacity auctions.

In January 2001, prior to the commencement of the fourth series of monthly entry capacity auctions in February 2001 Transco raised modification 0444, *'Extend Capacity Period Sold to 12 months in MSEC and MISEC auctions for February 2001'*. This proposal was raised in order to facilitate the move to longer-term auctions of entry capacity. This modification proposed that both MSEC and MISEC should be auctioned on a twelve-month profile rather than a six-month profile. It was argued that a move to auctioning capacity over a twelve month period would have provided shippers with more certainty regarding their capacity holdings for the year ahead, helping improve the planning of their annual gas production profiles.

The majority of respondents did not support this modification proposal. They expressed concerns regarding the uncertainty surrounding an extension of the capacity period given the short amount of time available before the commencement of the auction and the fact that the results of Ofgem's capacity investigation were still outstanding. In addition, respondents believed that the move to twelve-month auctions should have occurred for the entry capacity period 1 October 2001 to 30 September 2002, in order to align the period covered by the auction to the gas contracting year. Whilst Ofgem expressed its preference for longer-term auctions, we rejected the modification proposal on the basis of the concerns highlighted by the respondents.

In addition to conducting MSEC auctions, Transco also conducts monthly interruptible system entry capacity (MISEC) auctions. The first of these auctions was held in November 2000 for a period of 4 months December 2000 to March 2001 following Of gem's acceptance of Modification 410 *'Auctions of Monthly Interruptible System Entry Capacity'*. The second MISEC auction was held in March 2001, for a period of six month, April 2001 to October 2001.

Currently the Network Code provides for the sale of NTS entry capacity for a period of twelve months, from October 2001 to September 2002. The quantities to be made available for sale in the MSEC and MISEC auctions are to be based on historic gas flows for a 36-month period ending on 30 November 2000. Transco will publish these quantities on 30 June 2001. The Network

Code also provides that auctions of MSEC are to be completed no later than 31 August 2001 and that the auctions MISEC are to be completed no later than 15 August 2001 .

The modification proposal

This modification, raised by British Gas Trading, proposes the following:

1. The next series of NTS entry capacity auctions (both MSEC and MISEC) should only be for the six month period 1 October 2001 to 30 March 2002 rather than a twelve month period as currently set out in the Network Code
2. Auction quantities are to be calculated on the basis of historical gas flows taken over a 36 month period ending on 31 May 2001 rather than on 30 November in the preceding capacity year
3. Auctions for MSEC should be completed prior to the commencement of the MISEC auctions

In order to enable the completion of the MSEC auctions before the commencement of the MISEC auctions, the modification proposes to modify the Network Code to allow the completion of the MSEC auctions by 31 July 2001 and the completion of the MISEC auctions by 15 August 2001.

Respondents' views

Reduction in auction period to 6 months

The majority of respondents supported the proposal to reduce the auction period from twelve to six months. A number of respondents stated that moving to a six-month period for September 2001 to March 2002 would align the auctions with the beginning of the new price control period for Transco in April 2002. These respondents believed that there are considerable uncertainties surrounding the changes required to facilitate the introduction of long term capacity auctions from April 2002 within the context of the new price control. Respondents therefore argued that these uncertainties could increase risks for shippers and contribute to inefficient bidding if the auction were to extend beyond 31 March 2002.

One respondent suggested that it was inappropriate for Transco to auction capacity for a 12 month period October 2001 to September 2002 as offshore producers will not have finalised their maintenance programmes for the summer of 2002 until early 2002. This respondent indicated it would support 12-month auction periods from April to March in the following year. Another respondent indicated that it is inappropriate to auction capacity for the summer of 2002 in the absence of information on Transco's planned 2002-maintenance programme.

Other respondents, whilst supporting the modification, indicated that the capacity and gas years should be aligned such that any 12 month auctions occur from October to September in the following year.

Calculation of auction quantities over a 36 month period ending 31 May 2001

The majority of respondents supported the calculation of MSEC quantities based upon the most recent information available.

One respondent criticised the backward looking nature of the SND methodology, indicating that it does not recognise sufficiently new flows at particular terminals. The respondent indicated that this could create unnecessary constraints with insufficient capacity being made available in the auctions despite there being demand and the physical ability to satisfy it at a terminal. The respondent indicated that these inefficiencies are not fully addressed but are lessened by Transco calculating the amount of capacity it makes available using the most recent information on flows.

Completion of MSEC auctions prior to MISEC auctions

A clear majority of respondents agreed that the MSEC auction should be completed prior to the MISEC auction. One respondent commented that MSEC is the premium capacity product and as such should be auctioned prior to MISEC. Another respondent stated that it was inappropriate for Transco to offer an interruptible service in advance of bids for firm capacity being satisfied. One respondent indicated that MSEC must be auctioned before MISEC as interruptible capacity demand is influenced by the market's valuation for firm capacity.

A large number of respondents raised concerns regarding Transco's proposals to bring forward the date by which the auction of MSEC must be completed to 31 July 2001. These respondents argued that the revised auction timetable does not allow sufficient time for shippers to analyse Transco's entry capacity data due for release by 30 June 2001 and to develop their bidding strategies fully. Accordingly, several respondents and the majority of participants at the Energy and Capacity Workstream meeting on 20 June 2001 stated that the completion date for the MSEC and MISEC auctions should be postponed by at least four weeks.

A number of respondents also indicated that a postponement of the auctions will provide the industry with additional time to consider potential changes to the auction over and under recovery redistribution mechanism that are currently being discussed within industry workstreams. They stated that a delay in the auctions would allow industry participants to clarify the way forward for Transco's over-recovery adjustment mechanism.

A number of respondents identified a range of other issues that they believed would benefit from further consideration prior to the MSEC and MISEC auctions. These issues included the operation of Transco's capacity incentives and the treatment of interruptible capacity under the existing capacity regime.

Some respondents however expressed a preference for the completion of MSEC and MISEC auctions by 31 July. These respondents indicated that this would ensure that sufficient notice is provided of any adjustments to Transco's transportation charges that might arise from any over or under recovery against allowed revenue. This would give suppliers and customers certainty over transportation charges during their tendering processes. Other respondents however were not concerned by any reduction in notice periods associated with the adjustment of transportation charges.

Transco revised proposal

In view of the concerns expressed by the respondents and by participants at the Energy and Capacity Workstream meeting on 20 June 2001, the proposed MSEC and MISEC auction timetable contained in modification proposal 0465 has been revised. The revised timetable provides for the completion of MSEC auctions no later than 31 August 2001 and the completion of MISEC auctions no later than 15 September 2001.

Ofgem's View

In its July 2000 document *'The New Gas Trading Arrangements - A review of the new arrangements and further development of the regime - A review and decision document'* Ofgem indicated in reaching its decision on Modification 409 that it would prefer to see the introduction of longer term capacity rights for 12 or 18 months (leading up to the next price control period). Ofgem restated this view in reaching its decision on Modification 444.

We continue to prefer a move to longer term auctions. In particular, we consider that any move to longer-term auctions is consistent with Ofgem's objective of improving long term investment incentives and price signals. The introduction of longer-term auctions would provide shippers with a higher degree of certainty and stability regarding the structure of the capacity regime and their capacity holdings for the year ahead.

However, Ofgem recognises the concerns raised by respondents regarding the uncertainties associated with bidding for capacity prior to the resolution of the issues surrounding the introduction of long term capacity auctions from April 2002. In particular, Ofgem agrees that these uncertainties could increase the risks for shippers and contribute to inefficient bidding if the auction were to extend beyond 31 March 2002.

Ofgem agrees with the views expressed by respondents that the MSEC auctions should be completed prior to the commencement of the MISEC auctions. Ofgem also recognises the respondents' concerns regarding the original timetable proposed in this modification and the short time scale between the release of the MSEC and MISEC quantities and the completion of the auctions. In particular, Ofgem considers that it is important that shippers have sufficient time following the publication of capacity quantities to prepare their bidding strategies. As such Ofgem supports the revised proposal which provides for the completion of the MSEC auctions by 31 August and the completion of the MISEC auctions by 15 September 2001. In supporting the proposal, we recognise that, to take account of the MISEC auction results, any changes in the transportation charges effective from October 2001 would require a reduction in the notice period set out in the Network Code.

Ofgem agrees with the views expressed by respondents that MSEC and MISEC quantities should be based upon the most recent information available. As such Ofgem supports this element of the proposal. Ofgem also agrees with the concerns raised by one respondent about the backward looking nature of the SND methodology. Ofgem made clear in 1999, prior to the first round of auctions, that the SND methodology had a number of weaknesses and should not be used to determine capacity availability at terminals in subsequent sets of auctions. Ofgem is disappointed that alternatives to the SND methodology have not been advanced and/or discussed in depth at workstream meetings. Transco has recently published, as part of the price control review process, information that suggests that there is a reasonable degree of substitutability between certain entry terminals (and most notably Teeside, St Fergus and Barrow). This accords with experience from the capacity constraints in October 2000 where Transco was able to buy back capacity at the three terminals on different days to alleviate capacity constraints on the network. This would suggest that Transco will have to consider carefully whether the SND methodology remains an appropriate means of determining beach entry capacity in subsequent auction. It would also suggest that Transco should play a more active role in the day ahead and within day capacity markets buying and selling capacity at each of the three terminals if the relative prices at which capacity is bought and sold at each terminal continue to differ significantly.

Ofgem's Decision

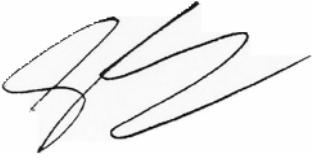
Ofgem has carefully considered the concerns raised by the respondents regarding the uncertainties associated with implementing an annual auction for the year 1 October 2001 to 30 September 2002. In particular, Ofgem believes that there is insufficient evidence to suggest that an annual auction, at this point in time, would better facilitate the economic and efficient operation of the transmission system or the securing of effective competition between relevant shippers and suppliers. Ofgem also considers that holding a twelve-month auction prior to the resolution of the details of the long-term investment regime may create considerable risks for shippers.

Although Ofgem has ongoing concerns about the SND methodology, in deciding whether to direct Transco to implement the modification, we must determine whether the proposal better facilitates the relevant objectives. As the proposal would see the SND methodology improved by the use of more recent information on terminal flows, Ofgem believes that this proposal would better facilitate the relevant objective of ensuring the economic and efficient operation of the transmission system.

Ofgem has therefore decided to consent to this modification, as we believe that it better facilitates 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.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'SS', written over a light grey rectangular background.

Steve Smith
Director, Trading Arrangements