

Development Workgroup Report **Modification Reference Number 0365**

1. Introduction

Ofgem indicated in its September RGTA decision document that it wished to see a within day capacity market established by April 2000. The establishment of such a market was debated during BC99/RGTA and is considered by some to be a logical and necessary enhancement to the entry capacity regime that was introduced from October 1999. Such a market would allow Transco and others to buy and sell capacity as appropriate beyond the current 13.00 hrs D-1 “gate closure” and would remove the potential for Transco to scale back shippers’ entry capacity which was seen by many as “arbitrary” and not recognising the value of entry capacity. The creation of such a market would also precipitate the need to review the quantity of interruptible capacity made available as the current level of interruptible capacity sales is intended to provide sufficient capacity availability should capacity requirements change within day due, for example, to demand increase or supply pattern changes.

Ofgem has indicated that a trading market for capacity should ideally be provided by an independent third party but to date this has not occurred. Modification proposal 0365 was raised by a shipper and requires Transco to provide a within day market. A Development Workgroup was instigated at the request of the Modification Panel to consider this proposal. This report sets out to summarise the discussions of that group to date.

Included within this report are the latest versions of the detailed business rules for Transco’s proposed within day capacity mechanism. In a number of areas there are square bracketed sections within these rules which reflect issues which either depend on systems development or where consensus could not be reached within the group.

2. Summary of Capacity Development Workgroup Discussions.

Following the Development Workgroup meetings for Modification 0365 which have taken place during December 1999 and January 2000, the principle areas of discussion can be summarised as follows:

2.1 Nature of Market

Transco has argued that it does not believe that it is its role to develop a sophisticated capacity trading platform which is similar in design to the on the day commodity market, although it may be that a third party would wish to provide such a market in the future. Transco however recognises merit in being able to increase and decrease the availability of capacity within the gas day and has proposed that it develops the equivalent of a capacity “flexibility mechanism” whereby capacity can be bought and sold by shippers, but Transco will always be the counterparty. Transco has also proposed that the registration of shipper

to shipper trades be entered in the RGTA capacity system, as opposed to AT Link, and that the mechanism provides a bulletin board facility where shippers can advertise that they wish to buy or sell capacity to other shippers. Some shippers have expressed a preference for a more sophisticated market, but others have agreed with Transco's view that a simple mechanism to increase and decrease the aggregate quantity is sufficient at this stage. No shippers were opposed to the transfer of trade registrations to the RGTA system and the ability to review an aggregate within day position that this provides.

2.2 Placing of bids

Under the existing arrangements, shippers are able to place bids from D-7 until 13.00 hrs on D-1. Transco initially proposed that bids could be placed before the day for the purchase or surrender of capacity for the whole of the day, or within day for the purchase or surrender of capacity in respect of part of the day. Shippers suggested that there be no distinction between before the day and within day requirements for bidding purposes, and that the start time of the bid should be dependent upon the timing of the bid. Transco agrees that this is appropriate. Transco has also proposed that shippers within day bids should be expressed as end of day quantities and that the facility be provided for bids to automatically be recalculated as the day progresses. Shippers expressed the view that both of these features would be useful and simplify bid placement.

A further area of discussion has been whether shippers should be able to see, on an anonymous, basis, the prevailing bid list in respect of buys and surrenders at each ASEP (Aggregate System Entry Point). There was general agreement within the group that this facility should be available within day to promote liquidity. However, some shippers expressed reservations as to whether this service should be available ahead of the day.

2.3 Linked Bids

The group discussed the potential value of linked bids whereby a shipper can place a bid to buy or surrender capacity and the acceptance of the bid is conditional on the acceptance of another bid(s) to buy or surrender capacity. Whilst the group felt there may be some benefit in being able to link an offer to surrender capacity to a bid to buy, in order to maintain an aggregate capacity position, other combinations were felt to be of little value. Transco explained how it could rank linked bids during selection by simply ascribing a unit value to the primary bid based on the differential between the linked components. Shippers felt that this was potentially over simplistic as it took no account of the value of transactions which could subsequently be carried out at the location of the linked component of the bid. Transco acknowledged this point but suggested that the development of further linkages in the selection process would prove too complex. It has subsequently proved to be highly unlikely that even basic functionality for linked bids will be available for 1st April and the group agreed that linked bids could be withdrawn from the proposal and potentially reconsidered at a later date.

2.4 Timing of Bid Acceptance

The group has discussed the timing of Transco's use of the within day capacity mechanism with an objective of ensuring that additional capacity can be accessed in a timely fashion. Transco initially proposed that it would ideally review the availability of System Entry Capacity and the corresponding available bids on an hourly basis. Transco however stressed that this would require significant improvements in the processing time of bids and that this may not be possible for 1st April implementation. A number of shippers indicated that this would be an appropriate frequency for the review of capacity services. Some Workgroup members suggested that ordinarily there would be no need for frequency of this activity within day. Transco has subsequently proposed that it continues to assess bids on D-1 at 13.00 hrs. and notifies shippers by 15.00 hrs. Subsequent reviews would then take place after demand attribution times and following changes in the availability of both onshore and offshore plant. Workgroup members appeared to be of the view that this would be acceptable provided that Transco continually seeks to offer the maximum amount of capacity for the prevailing conditions to the extent that shippers wish to buy it, and that an important consideration is the speed at which Transco can process bids. As has previously been indicated, the existing processing requirements require two hours but Transco's intention is to revise systems to allow for the processing of bids within an hour.

One shipper questioned whether bidding screens would briefly "freeze" whilst bids were accepted as was the case with the Flexibility mechanism. Transco confirmed that this would be the case.

It has also been suggested that Transco could accept some bids for the purchase and surrender of capacity ahead of D-1. Transco's view is that the level of demand information available in advance of midday on D-1 is not robust enough to base buying and selling decisions on and that, in any case, it will not be possible to revise systems to facilitate this in time for 1st April implementation. This issue should therefore be reconsidered at a later date.

2.5 Payment for daily capacity services

Daily capacity services are currently based on the lowest priced accepted bid on D-1 multiplied by the bid quantity, known as the clearing price. Transco is of the view that this should be revised so that shippers pay the accepted bid price. Transco has argued that this will remove a feature of the existing incentive regime where Transco can effectively earn less money by releasing additional capacity, which depresses the clearing price. It should however be noted that Transco's policy has been to maximise capacity availability as opposed to maximise revenue. A further perceived weakness in the existing regime is that shippers could place higher priced bids safe in the knowledge that they will pay a lower clearing price and effectively push up the overrun charge and increase the value of their capacity on the secondary market. Transco's view is that "pay your bid" pricing will help to address these points, and is more suitable for the proposed market where capacity can be sold at several times during the day as opposed to in a single transaction on D-1 as is currently the case. A number of shippers within the group have suggested that they would prefer the retention of a cleared price mechanism based on the lowest priced bid accepted at any time when capacity is sold.

2.6 Role of Interruptible Capacity

A significant area of discussion within the group has been the future role of interruptible capacity. Transco has expressed the view that under the current arrangements, where interruptible capacity is sold on an almost unrestricted basis, when the actual capacity of the system increases within day there is little or no likelihood of interruption. This effectively means that shippers enjoy a firm service at an interruptible price. A number of shippers have expressed some concern over the removal of the service due to the flexibility it provides. They argue that in circumstances where supply patterns need to change at short notice the use of low cost interruptible capacity allows for a rapid renomination. Transco has argued that shippers will be able to go to the market and place bids for additional firm capacity in such circumstances and that, provided shippers place bids in a timely fashion, Transco's response times will not be significantly out of step with offshore nomination time scales. Shippers have expressed a further concern that Transco will delay the release of capacity to foster higher bid prices. Transco's view is that this is unlikely to happen given the constraints on behaviour imposed by the PGT Licence and Competition Act. One shipper however, offered the view that until such time as interruptible capacity is removed the development of secondary trading will always be impaired.

2.7 Reserve Price for Daily Capacity Auctions

Shippers have strongly expressed the view that the present reserve prices for daily firm capacity have been set too high, but that this is currently offset by the availability of low cost interruptible capacity. Transco has acknowledged that it is appropriate to review the level of reserve price set for daily firm capacity in the context of a within day capacity market with limited interruptible capacity. Transco has also reiterated its position that the pricing of daily firm capacity should encourage shippers to participate in the primary auctions for the majority of their needs. Shippers have clearly stated that their views on the appropriateness of a within day market are critically dependent on the reserve price charged for daily firm capacity. In response to this, Transco has confirmed that reserve prices would have to be the subject of a pricing consultation and are, in process terms, a separate matter. However, Transco recognises the need for shippers to view a "complete picture" and have indicated that any pricing consultation will be, to the extent possible, concurrent with the modification consultation.

2.8 Future of "Use-it or Lose-it"

The question of whether there was still a role for "use it or lose it" interruptible capacity was briefly considered. Transco asked the group if the issues of hoarding, which had originally precipitated the development of this service, were still valid. There was general agreement that there was still a role for this service. Transco suggested that this question could potentially be revisited if and when a third party developed a more sophisticated trading platform for capacity. Until that time Transco confirmed that it intended to continue to provide "use it or lose it" capacity on D-1 in the same manner that it does at the present time. The question of "use it or lose" capacity being made available within day

was briefly discussed with Transco expressing the view that this may prove to be complex and that it did not intend to provide such a service.

2.9 Constraint management following market failure

One of the primary objectives of the within day market is to remove the need for Transco to “scale back” firm capacity rights within day. Transco confirmed that it intends to address within day constraints by using the market to buy back firm capacity rights but suggested that there would still be a need for a fall back mechanism. This would address circumstances where the market has failed, either for systems reasons or where, for whatever reason, there are insufficient surrender bids to address a constraint. Shippers reaffirmed their wish for the market to be used to the full extent possible to address within day constraints but acknowledged the need for some form of default mechanism. Transco suggested that there were two options, first to retain the existing scale back and, where scale back is inappropriate, to “fail to accept gas tendered for delivery”, or second (in recognition of the fact that market failure should be a rare occurrence) to rely on the “failure to accept gas” provisions. In both cases, Transco would still potentially pay liabilities to the affected shipper, but the basis of this would need to be changed to reflect the bid prices available at the time of market failure, as opposed to the prices available at 13.00 hrs. on D-1. Shippers were asked for their views, but no clear preferences emerged. Transco proposes that this subject be addressed through the modification consultation process. However, it should be noted that there is some complexity in effecting a scale back where additional capacity has been released within day and, as this is essentially a contingency measure, the “failure to accept gas tendered for delivery” approach may be more appropriate and achievable.

3. Workgroup Recommendations

3.1 Workgroup consensus

In Transco’s view, the Workgroup has reached a consensus on the following points:

- ◆ Within day constraints should ordinarily be addressed by a market mechanism as opposed to scale back.
- ◆ Within day, shippers should be able to view on an anonymous basis all live bids in relation to an ASEP.
- ◆ No distinction should be made between bids placed before the day or within day. The system derived effective registration/surrender time will dictate the status of a bid as within day or day ahead.
- ◆ Use it or Lose it capacity should be retained in its current form.
- ◆ Transco should use the market at the times identified in the business rules and ideally respond to such activity by notifying shippers of successful bids within an hour.

- ◆ Shippers should be able to bid in end of day quantities and bids should be capable of automatic recalculation as the day goes on if the shipper identifies the bid as recalculable.
- ◆ The facility for linked bids is potentially complex and of questionable benefit, and should be removed from the specification of the market for 1st April.

3.2 Areas where no agreement has been reached.

In Transco's view the following issues have not been resolved within the work group and a modification consultation process is the appropriate platform for further debate:

- ◆ Whether or not interruptible capacity should be sold up to the "1 in 20" peak level as is currently the case.
- ◆ Shippers ability, or otherwise, to view bids on an anonymous basis ahead of the gas day.
- ◆ Whether the payment for daily capacity should be on a "pay your bid" basis or a "cleared price" as is currently the case.

In addition to the above specific points, some members of the Workgroup have expressed concern over the desirability of a within day market and the timetable upon which it is being developed. They say that existing arrangements are working satisfactorily as capacity is readily available and interruptible capacity provides sufficient insurance against within day changes.

In terms of the development time allowed for this proposal, some shippers are of the view that the proposed 1st April implementation allows insufficient time both for the development of the service, and the development of business systems to support the service. In view of this, some shippers have suggested that it may be appropriate to delay implementation until May, June or possibly even October. However, other shippers are of the view that this service should be implemented for 1st April and that sufficient notice has been given through Ofgem's decision document published in December 1999.

3.3 Transco Opinion

Transco remains of the opinion that the development of a within day market for the buying and selling of System Entry Capacity is a logical next step in the RGTA process. As is currently the case with energy trading, it may be appropriate for a third party to facilitate a screen based cleared market for capacity trading. However, until an effective independently run market has been established, Transco believes that the proposed within day mechanism provides an appropriate means for the increase, decrease and redistribution of capacity rights.

The issue of interruptible capacity availability has prompted discussion both within and outside of the Workgroup but Transco believes that the need to sell interruptible capacity to the extent that it is currently sold is a direct result of there being no within day market.

Consequently the development of a within day market will remove the need for interruptible capacity other than that derived on a “use it or lose it” basis or that which could be attributed to the uncertainty level of Transco’s firm capacity availability calculations on D-1.

Transco believes that charging for daily capacity on a “pay your bid” basis is a worthwhile step as it will achieve the following objectives:

- ◆ Transco’s potential reward under the incentive scheme will be more closely aligned with shippers’ desire that Transco maximises the level of capacity it make available.
- ◆ Overrun charges, which have an effect on secondary market prices, are less likely to be manipulated by shippers buying quantities of capacity at high prices as they would have to pay the high price as opposed to a potentially lower clearing price.
- ◆ Daily pricing would be consistent with the pricing for Monthly System Entry Capacity.

In terms of the timing of implementation, Transco is of the opinion that a 1st April start is desirable and achievable, but that some slippage to ensure that systems are sufficiently tested and robust would not be inappropriate if that proves necessary. However, it is important that shippers are fully aware of the start time of a within day market at the time of the next round of monthly capacity auctions as its existence, or otherwise, is likely to influence bidding strategies.¶

Transco recognises shipper concerns regarding the pricing of daily firm capacity services and is considering the possibility of a reserve price reduction which would be the subject of a pricing consultation exercise.

4. Extent to which the proposal would better facilitate the relevant objectives

Transco believes that this proposal may better facilitate the relevant objectives in two ways.

Firstly in respect of the “efficient¶ and economic” operation of the pipeline system. The proposed mechanism ensures that the available transportation capacity can be allocated to shippers on the basis of their own valuation. Under the existing arrangements capacity is allocated and surrendered on the basis of price ahead of the day, but within day changes, if needed, are conducted on a uniform basis which does not take account of shippers valuations. The proposal will provide the potential for allocative efficiency to be achieved within day as well as ahead of the day.

The second area in which the proposal may better facilitate the relevant objectives is in the promotion of competition between shippers. This proposal will allow shipper greater control over their capacity rights by increasing the within day “firmness” of the service. This may provide a better platform for shippers to develop delivery flexibility in order to take advantage of the proposed market and potentially achieve lower costs by responding to price signals.

5. The implications for Transco of implementing the recommendations, including :

5.1 implications for the operation of the System :

The introduction of a within day capacity market will represent a change in the way Transco optimises and makes available entry capacity. Other than to address market failure, it will remove the need for capacity scaling and allow Transco to 'buy back' capacity or make additional capacity available on a real time basis within the gas day.

Transco will be required to assess the level of entry capacity availability at each ASEP and the level of demand for that capacity on a frequent basis within day, and to make decisions on whether to buy or sell capacity through the proposed mechanism.

5.2. development, capital cost and operating cost implications :

Transco will incur significant IT development costs associated with the provision of a within day capacity market, a capacity registration service and a shipper bulletin board. Transco will absorb these costs within the present price formula.

The increase in the administration effort to support daily capacity auctions and the allocation of capacity will represent an increase in operating costs.

5.3 extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs :

Any additional development and ongoing costs will be accounted for under the price control formula and Transco does not intend to seek additional costs for the provision of the within day market in the present formula period.

5.4 analysis of the consequences (if any) this proposal would have on price regulation :

The recommended changes are not anticipated to have immediate price regulation consequences. However, the introduction of within day capacity auctions and the effect this may have on shippers' strategy towards monthly capacity auctions may have an impact on the level of revenue Transco recovers through Monthly System Entry Capacity which will feed through to 'k' in the present price control formula.

5.5 Consequence of Implementing the Proposal on the level of contractual risk to Transco

The introduction of the within day market may attract further scrutiny to Transco's incentive scheme and the way it balances its financial incentives against the objective of maximising capacity availability. This may lead to claims that Transco is not operating the System in an economic and efficient manner. The proposal may also introduce uncertainty to the bidding strategy of shippers which will increase the level of contractual risk to Transco.

The effectiveness of the regime to secure or release capacity and, in the event the regime fails, the effectiveness of the contingency could impact on the level of contractual risk to Transco.

6. The Development Implications and other Implications for Computer Systems of Transco and related Computer Systems of Users

Transco's computer systems require significant development to facilitate the introduction of a within day capacity mechanism and are being modified on the basis that the principles of the existing D-1 auction will be incorporated into the new process.

The support systems that are used to assess the optimal level of capacity availability at each ASEP and the allocation of capacity to shippers will also require development to handle the increase in complexity and provide an improvement in response times as deemed necessary.

Further system developments are needed to automatically update shippers' capacity holding positions, including taking account of prearranged capacity trades between shippers that have been registered with Transco.

Transco's provision of a capacity bulletin board service has also required the building of a new system which has to be compatible with the RGTA capacity system.

The specification of the new systems have been designed such that they can interface with third party computer systems to cater for the possible event that a capacity market could be provided by a third party market operator, similar to the arrangements for the OCM.

Changes in invoicing production have been necessary to introduce new charge types which will indicate shipper 'buys' and 'sells' of daily capacity.

Users will require an understanding in the use of new computer screens for the placing of bids and their capacity allocation, in addition to the changes in invoice types.

7 The Implications of Implementing the Proposal for Users

Users will have the opportunity to purchase and make available daily capacity beyond the present gate closure of 13:00 hours at D-1.

The use of the new RGTA capacity system together with the capacity registration service and the bulletin board service will provide a means to continually update shippers' capacity entitlement and allow shippers to view their capacity position.

Users will be required to register any prearranged (or OTC) capacity trades with Transco, and are also offered a bulletin board service which will allow shippers to "advertise" to buy or sell capacity.

Consistent with the provision of a within day capacity market, which will further provide shippers with an opportunity to match their capacity holdings to their requirements for a day, the levels of interruptible capacity which have previously been made available at D-1 is likely to be significantly reduced and the role of interruptible capacity diminished.

8 Implications of Implementation for Terminal Operators, Suppliers and Producers, and any Non-Network Code Party

Improvements in the use of daily capacity service may reduce the likelihood of terminal constraints and thus the likelihood of large flow rate reductions at entry points.

Procedures for managing constraints will be changed to reflect the implementation of this proposal.

9 Consequences on the Legislative and Regulatory Obligations and Contractual Relationships of Transco and each User and NNCP

The setting of a revised reserve price for Daily System Entry Capacity would be subject to a pricing consultation exercise.

10 Analysis of any advantages or disadvantages of implementation of the Modification Proposal :

Advantages

- i. Allows shippers to adjust their capacity holding level for any gas day beyond the present cut-off of 13:00 hours D-1
- ii. Creates better alignment between Transco's reward potential under the incentive mechanism and shippers' desire to see available capacity maximised.
- iii. Replaces the process of "scaling back" capacity with a regime that recognises the value that individual shippers place on capacity
- iv. Potentially increases liquidity in secondary trading of capacity

Disadvantages

- i. May reduce perceived importance of advance booking of monthly capacity
- ii. Introduces a risk of Transco releasing capacity with subsequent buy-backs within day
- iii. Cost and complexity of the proposed changes may outweigh the anticipated benefits

11. Summary of Representations (to the extent that the import of those representations are not reflected elsewhere in this Report)

Representations will be summarised in the Final Modification Report.

12. Any other matters that need to be addressed for production of the Modification Report

No further matters have been identified.

13. Comment upon & make recommendations re implementation timetable

Subject to satisfactory completion and testing of systems, the recommended implementation timetable, if the Modification Proposal is implemented, is as follows :

1. Shippers capacity bid window opens for Daily System Entry Capacity
 - 25 March 2000 (at D-7 for 1 April 2000)
2. Commencement of Within Day Capacity Auctions
 - 31 March 2000 (at D-1 for 1 April 2000)

14. Comments upon the proposed text (if appropriate)

A copy of the proposed business rules is attached and comments are sought as part of this consultation.