

Direct Dial: 020-7901-7437

13th February 2001

Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/0452

Dear Colleague,

Modification Proposal 0452 '*Removal of Monthly Capacity Incentive Limit Amounts*'

Ofgem has considered the issues raised in Modification Proposal 0452 '*Removal of Monthly Capacity Incentive Limit Amounts*'. Ofgem has decided to direct Transco to reject the modification, because we do not 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

Transco conducted the first auctions for the sale of entry capacity to its National Transmission System (NTS) in September 1999. The auctions provided for the allocation of monthly firm system entry capacity (MSEC) to successful bidders for a total period of 6 months from October to March 1999. A second series of auctions was held in March 2000 for the period April to September 2000 and a third series was held in August 2000 to the period October 2000 to March 2001. Further from 1 December 2000 Transco released interruptible capacity on a monthly basis.

In addition to holding monthly auctions, Transco makes additional firm and interruptible capacity available on a daily basis and conducts capacity buy-backs where necessary. In order to encourage Transco to maximise the volume of daily capacity and provide it with an incentive to manage constraints in an efficient manner, an incentive regime was put in place on 1 October 1999. Under this regime Transco retains 20% of any additional revenue associated with the sale of daily firm and interruptible capacity. Conversely, Transco is liable for 20% of the costs of buying back capacity in the event of a constraint. The incentive was constructed to be based around a zero mean, with the likely value of daily capacity sales being offset by the likely value of buying back capacity in the event of the constraint. The revenues and costs accruing to Transco over the year of the incentive have a cap and collar of +/- £5 million.

The annual cap and collar is broken down into equal monthly caps and collars to ensure that Transco does not prematurely reach its annual cap or collar, thereby reducing the incentive to maximise daily capacity volumes and minimise buy-back costs.

In October 2000, Transco experienced severe capacity constraints on the NTS, mainly at the St. Fergus terminal, due to demand being below its expected level. As a consequence, Transco was forced to buy-back significant levels of capacity often at very high prices. As a

result Transco reached its £416 000 monthly cap for buy-backs for the month of October. The total cost of buy-backs for the month of October reached approximately £8.5 million. When Transco reached its cap under the incentive scheme, all of the remaining costs were smeared back to shippers on the basis of their holdings of monthly system entry capacity.

In this context BGT raised modification proposal 430, '*Removal of monthly incentive limit amount*' and requested that Ofgem grant urgent status to the proposal. By proposing to remove the monthly cap and collar the proposal sought to ensure that the commercial incentive on Transco to continue to minimise the costs of buy-backs (and indeed maximise the availability of capacity) was maintained throughout an individual month subject to the annual cap and collar being reached. Ofgem rejected urgency for this modification proposal since Ofgem believed that for incentives to be effective, they must not be materially changed within the agreed period with the benefit of hindsight. In addition Ofgem believed reopening the incentives in the light of a few days of capacity constraints could undermine the credibility of any future incentive regime. BGT subsequently withdrew the modification proposal.

Since October 2000 Transco has bought back capacity on a number of occasions. The total cost of buy-backs since October 2000 is approximately £11.6 million with Transco carrying a net deficit position of approximately £870 000.

The modification proposal

The modification proposes the removal of monthly caps and collars on Transco's capacity incentive to strengthen commercial incentives on Transco to minimise costs of capacity constraints and maximise volumes of capacity made available at the day-ahead stage. The modification proposes the retention of the annual cap and collar of +/- £5 million.

Respondents' views

A majority of respondents expressed support for the modification proposal. Of those supporting the proposal, most believed that a removal of the monthly capacity limits would provide a stronger incentive on Transco to minimise costs and maximise revenue. One respondent believed this would align Transco's incentives with those of shippers, whilst another questioned the requirement for artificial limits on revenue and risk for Transco when it has been shown that both the cap and collar have been breached without difficulty. Another respondent however, expressed concern that removal of the caps and collars should not mean a reduction in the volumes of capacity Transco makes available to avoid buy-back costs.

Those shippers opposing the proposals to remove monthly caps and collars did so largely on the basis that 'piecemeal' changes to the capacity incentive regime are inappropriate. One respondent suggested that the incentive regime should be considered as a whole, having regard to both the annual and monthly caps and collars, the effectiveness of constraint management by Transco, Transco's release of additional capacity and whether or not the incentive sharing factors provide a desired level of risk and reward for Transco and shippers.

Shippers opposed to the proposal believed that the removal of the monthly cap and collar could weaken the incentive if Transco were to reach its annual cap and collar prematurely, since Transco would no longer be incentivised to minimise costs of constraints. One respondent suggested that consideration be given to an alternative mechanism whereby the annual cap and collar is divided between months or days in a more effective way. The same respondent also queried how cash-flows under any revised incentive would be managed in the event that Transco reached its annual cap and collar prematurely. Concerns were also

raised that the proposal did not properly consider the interaction between the proposal and the timing and length of the capacity year.

Ofgem's View

In its July 2000 document¹, Ofgem undertook a review of Transco's capacity incentive. We found that the incentive scheme showed a positive bias during the first six months of its operation. Ofgem stated, at the time, it would welcome exploration of potential changes to the capacity regime to address this positive bias and indicated that we would like to see the caps and collars and sharing factors increased over time to sharpen Transco incentives.

Similarly, in its decision on modification proposal 0417 *'Revisions to the capacity incentive'* Ofgem indicated it was interested in exploring the impact on the current incentive of the recent changes to the capacity regime including the increase in the amount of MSEC made available and the removal of a proportion of interruptible capacity revenue from the incentive regime into the price control. In particular, Ofgem indicated that it would welcome a discussion on whether these changes to the regime would continue to base the incentive around zero.

Whilst Ofgem recognises many of the concerns expressed by shippers regarding the impact of monthly caps and collars on Transco's commercial incentives to minimise the costs of capacity buy-backs, we do not believe it is appropriate to review and adjust one parameter of the incentive regime in isolation. Further, Ofgem agrees with the views expressed by some respondents that a removal of the monthly incentive limits without an increase in the annual cap and collar could lead to a severe weakening of the capacity incentive if Transco were to prematurely reach its annual limits.

Under the current regime, if Transco were to reach their annual cap early in the incentive year, any additional costs incurred due to capacity constraints would be smeared back across all participants, with Transco having no exposure. Given recent changes to the capacity regime including increases in the level of MSEC and the introduction of the monthly interruptible system entry capacity (MISEC) product, Ofgem considers this to be a very real possibility. Accordingly whilst Ofgem is generally supportive of the removal of the monthly caps and collars we do not support the implementation of this modification proposal in isolation.

In this context, Ofgem continues to believe that all of the parameters of the existing capacity incentive including caps and collars and sharing factors are in need of review. Indeed, Ofgem has previously made its view clear that the existing incentives should be reviewed after one year's operation with a view to increasing the sharing factors and caps and collars. This view was reflected in both the July 2000 NGTA review document and in the decision letter on Modification proposal 0417. Ofgem is therefore disappointed to note that such a review was not initiated by Transco or a shipper last year.

Ofgem considers that a review of the incentive should address the interactions between the parameters as well as other factors including the volumes of capacity released in the monthly auctions. In addition, it should consider the impact of increases in the level of MSEC and MISEC on the incentive and whether or not these changes will base the incentive around zero.

¹ *'The New Gas Trading Arrangements A review of the new arrangements and further development of the regime A review and decision document.'*

As mentioned above, Ofgem continues to believe that any review should consider increasing both sharing factors and caps and collars to sharpen the incentives on Transco to both minimise buy-back costs and maximise available capacity on the day. In the event that any review concludes that the incentive is negatively biased then consideration could also be given to providing Transco with funds to manage the costs of buy-backs.

Ofgem believes that a review of the capacity incentive should commence immediately and that any change to the incentives could be implemented immediately following the review on a forward-looking basis. In this regard Ofgem is not convinced by the view that it would be inappropriate to change the incentive for the period from say 1 April 2000, once the summer capacity auctions have concluded. In particular, some market participants have argued that it is inappropriate to adjust the incentive following the monthly auctions as shippers consider the parameters in the incentive when preparing bid strategies.

However, for the reasons set out in its letter to Transco and shippers of 17 October 2000 relating to the capacity buy-back market, Ofgem does not believe that shippers bids in the daily buy-back market should be influenced by the parameters of the capacity incentive such as the sharing factors. In particular, bids in the daily buy-back market should not be designed to take into account a shipper's prospective liability or revenues associated with smeared costs and revenues under the daily incentive mechanism. Inevitably, a shipper's valuation of monthly capacity will be influenced by their expectations of prices in the daily market (ie any sustained difference in prices could be arbitrated). Therefore, Ofgem do not believe that changes to the incentive parameters would necessarily materially impact on a shipper's valuation of monthly entry capacity. As such, Ofgem believes that the completion of the forthcoming round of monthly capacity auctions should not prevent a comprehensive review of the capacity incentive commencing immediately.

Ofgem's Decision

Ofgem does not support this modification as we consider that with a removal of the monthly capacity incentive cap and collar, Transco may reach its annual cap and collar early in the capacity year. This would weaken its incentives to maximise daily capacity or minimise the costs of capacity buy-backs in the remainder of the capacity year. Ofgem does not believe that a weakening of these incentives would better facilitate the efficient and economic operation of the NTS by Transco.

Accordingly therefore Ofgem has decided to reject this modification, as we do not believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Public 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,

Mark Feather
Head of RGTA