

Draft Modification Report
Abolition of Entry Capacity Reserve Price
Modification Reference Number 0507
Version 1.0

This Draft Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

Norsk Hydro (UK) Limited proposes that reserve prices are removed for entry points where historically competition exists which should be determined by an excess of five active bidders.

2. Transco's Opinion

Since the introduction of entry capacity auctions, consistent with its licence obligations Transco has supported the use of reserve prices at all terminals. Transco believes that reserve prices can play an important role in minimising the ability of any players abusing market power. In setting reserve prices Transco has sought to avoid distortions to the auction process and bidders valuations, thereby promoting efficiency while avoiding undue preference in the supply of transportation services. Transco is not therefore in support of the modification proposal.

Transco is particularly concerned by the proposer's suggested definition of "competition" at entry points. Although the number of bidders is a guide to the level of competition, there may well be one dominant player at an entry point capable of exercising market power. Transco believes a better measure would be the use of concentration ratio or the Herfindahl-Hirschman index, as described in Transco's Pricing Consultation Paper (PC48 - "Methodology for determining floor prices for auctions of monthly entry capacity"). Both of these measures suggest that all entry capacity auctions to date have been highly concentrated.

Transco observes that the proposal does not specify whether the removal of reserve prices is intended to apply to short term capacity auctions or long term capacity auctions, subject to the final business rules for the capacity auction in the new price control period (i.e. 1 April 2002 onwards). The removal of reserve prices and the possible reduction in entry capacity revenue could create different outcomes depending on the type of auction. Whereas in short term auctions, if the recoverable revenue falls below the allowable revenue, then this raises issues of how the shortfall is recovered through the price adjustment mechanism 'K'. However, under Ofgem's final proposals for the SO incentive mechanism, if the revenue recovered in the long term auctions is below the cost of providing additional capacity then Transco may not be incentivised to commit to additional reinforcement because of the unacceptable level of business risk it would face.

As reserve prices are calculated from administered charges based on the long run marginal costs of increasing capacity they may be said to be cost reflective and therefore it could be argued that their retention ensures a greater degree of cost reflectivity.

3. Extent to which the proposed modification would better facilitate the relevant objectives

The Proposer is of the opinion that the Modification Proposal would better facilitate the relevant objectives by reducing the discriminatory effect that the revenue redistribution resulting from the auction process has on sectors of the UK Gas Market.

In Transco's view the proposed modification could introduce instability in transportation charges which would not facilitate competition between shippers and suppliers, and in respect of long term capacity auctions could act as a disintive to Transco in reinforcing the transportation system which would not be expected to better facilitate the economic and efficient operation of the pipeline system.

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

Transco does not anticipate any such implications.

b) development and capital cost and operating cost implications:

Transco does not anticipate any such costs.

c) 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:

Transco anticipates that the implementation of this Modification Proposal would not lead to an increase in costs.

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

Any under-recovery that could arise as a result of implementation of the modification proposal would be met via an adjustment of other NTS charges. This may be viewed as inconsistent with Transco's licence obligations and may lead to instability in the level of charges.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

No such consequences are envisaged.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

If the modification proposal contemplates a reduction in the reserve prices to zero, no such implications are envisaged.

7. The implications of implementing the Modification Proposal for Users

At those entry points where competition exists, as defined by the Modification Proposal, Users bidding for entry capacity at those entry points will not be required to bid at prices greater than a reserve price. Subject to the effect on levels of under-recovery, Users could face increased volatility in transportation charges.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

There may be an impact on end-users' charges, depending on whether Shippers pass on any changes in transportation charges.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

No such consequences are envisaged.

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

Advantages :

Avoids possible distortion of bidders valuation of entry capacity
Retains measure to minimise possible abuse of market power

Disadvantages :

May increase likelihood of under-recovery and volatility in transportation charges
May weaken investment signals, thus discouraging Transco to invest in system reinforcement
Would leave uncertainty in respect of defining "competition" at entry points

The proposal does not distinguish between short term and long term capacity auctions.

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

Representations are now sought as part of this Draft Modification Report

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Transco is unaware of any such requirement

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Transco is unaware of any such requirement.

14. Programme of works required as a consequence of implementing the Modification Proposal

As implementation would not impact on the UK Link systems, a program of works is not required.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Transco does not recommend implementation and therefore has not proposed an implementation timetable.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends rejection of this Modification Proposal.

17. Text

No legal text has been provided because Transco does not recommend the implementation of this Modification Proposal.

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date: