OFGEM DECISION LETTER No. 0507
"Abolition of Entry Capacity Reserve Price"
Version 1.0

Direct Dial: 0207-901-7437

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Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0507: Abolition of Entry Capacity Reserve Price

Ofgem has considered the issues raised in Modification Proposal 0507 *'Abolition of Entry Capacity Reserve Price'*. Ofgem has decided to direct Transco not to implement the modification because we believe that this proposal does not better facilitate the relevant objectives of Transco's Network Code.

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 New Gas Trading Arrangements (NGTA), Transco introduced monthly and day-ahead pay-as-bid auctions of entry capacity as an efficient and non-discriminatory mechanism for the allocation of entry capacity. The first auctions for the sale of firm, monthly system entry capacity (MSEC) to the National Transmission System (NTS) were held in September 1999 for the period October 1999 to March 2000. Further auctions for MSEC were held in March 2000, August 2000, February 2001 and September 2001. The next series of MSEC auctions are due to commence on 15 February 2002.

In addition to conducting MSEC auctions, Transco also conducted Monthly Interruptible System Entry Capacity (MISEC) auctions from November 2000. As a result of our decision today on Modification Proposal 0499, *'Transitional Arrangements for Long Term Capacity Allocation'*, the MISEC product will be discontinued.

Transco also releases firm and interruptible capacity on a daily basis where there is additional physical capacity available. In the event of a constraint at an entry point (when physical capacity available is less than capacity sold against which gas is flowing) Transco can buy back the capacity until the constraint is relieved.

Reserve prices

Prior to the introduction of the entry capacity regime, Transco argued that reserve prices for entry capacity were necessary in the proposed auctions to address the issue of buyer market power at certain terminals where competition was restricted. It was argued that in the absence of reserve prices, Transco's price control revenue would be at risk at terminals where there is a lack of effective competition between shippers. In addition, it was argued that significant over or under-recovery of revenue would have large cash flow implications for Transco as well as having a large impact on other, future transportation charges.

Under the methodology established by Pricing Consultation 48, '*Methodology for Determining Floor Prices for Auctions of Monthly System Entry Capacity*', MSEC reserve prices were set at 75 per cent of

Transco's estimate of the Long Run Marginal Cost (LRMC) at each entry terminal. Transco estimated LRMCs on seasonal profiles of capacity and adjusted them to ensure that when applied, they would result in recovery of their target revenue. A common discount was applied equally to all terminals to ensure that the reserve prices were set on a non-discriminatory basis across terminals. Reserve prices were also set for daily auctions of entry capacity and for sales of day-ahead interruptible capacity Pricing Consultation 49, '*Prices for Unsold Monthly Capacity and floor prices for daily capacity auctions'*..

Ofgem chose not to veto PC 48 on the basis that reserve prices may be necessary to protect Transco where there is a lack of effective competition between shippers at a terminal.

Prior to the August 2000 auctions, Transco raised Pricing Consultation 61, '*Monthly System Entry Capacity Floor Prices,'* that proposed to re-calculate LRMCs to reflect an increase in MSEC volumes that were to be made available in these auctions. In its decision on PC61, Ofgem stated that it believed experience to date in the auctions suggested that there was sufficient competition at the majority of large beach entry terminals to guard against significant revenue under-recovery. Ofgem noted in its review that reserve prices in the monthly auctions were only necessary to protect Transco at entry terminals where there is a lack of effective competition between shippers. Ofgem expressed concern that the continuing use of reserve prices may, at certain times, prevent all capacity reaching the market. Ofgem also made clear that it did not believe that concerns about revenue under-recovery should be given much weight in the light of the outcome of the first (and second) set of auctions.

Further, Ofgem commented at the time that the revenue under-recovery mechanism established by Pricing Consultation 60 '*Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS auctions',* provided sufficient revenue protection to Transco from under recoveries. Under PC60 any under or over recovery is addressed within a dead-band of +/- 10% through 'K'. Where the deviation is greater than 10% the methodology provided that NTS commodity charges are adjusted subject to this charge being reduced to no lower than a minimum level with any remainder being distributed through 'K'.

Ofgem therefore accepted the proposal on the basis that it represented an improvement on the existing pricing methodology and noted that if reserve prices prevent all capacity reaching the market this could place Transco in breach of its licence obligations.

The impact of PC61 reduced reserve prices for the winter 2000 MSEC auction by, on average, 20 per cent. Reserve prices for daily interruptible capacity were set at zero.

Following the introduction of the MISEC product, Transco raised Pricing Consultation 63 ,*'Monthly Interruptible System Entry Capacity Floor Prices'* that set reserve prices for MISEC at a 90% discount to LRMC levels. Ofgem elected not to veto this proposal.

Reserve prices were further reduced prior to the commencement of the winter 2001/2 MSEC auction, to reflect the higher volumes of entry capacity that were offered for sale at all entry terminals in the auction, following Ofgem's acceptance of Modification Proposal 0481, *'Release of ASEP maximum system entry capacity volumes for MSEC auction'*.

It is noted that reserve prices also apply to daily firm system entry capacity following Ofgem's acceptance of Pricing Consultation 62, '*Daily System Entry Capacity Floor Prices,'* in July 2000. These reserve prices are set at a 50% discount to LRMC. There are no reserve prices for daily interruptible system entry capacity.

Ofgem's Final SO incentive proposals

The final proposals for Transco's SO incentives for 2002-7 will introduce longer-term auctions of entry capacity and include an entry capacity incentive to encourage Transco to invest in NTS entry and exit capacity where it is efficient to do so in response to its customers' changing needs. The proposals are also intended to improve the incentives on Transco to carry out its day-to-day role of operating the NTS economically and efficiently. Under these proposals, Transco will be required to offer for sale entry capacity that will be sold through a series of auctions of longer and shorter-term firm, tradable capacity rights. Prices emerging from these auctions and subsequent trading of capacity, will improve the signals to Transco of the need for additional investment in new capacity, by providing Transco with an indication of the value shippers place on entry capacity.

With respect to auctions of long term entry capacity, in its March 2001 document'*Long term signals and incentives for investment in transmission capacity on Transco's National Transmission System - The New Regime,*' Ofgem, March 2000.
, Ofgem has accepted the need for some form of floor price (either implicit or explicit) in relation to additional capacity. This would avoid the possibility of Transco having to commit to build new capacity where the price offered in the auctions did not cover the costs associated with providing the capacity. Whilst Ofgem accepts the need for some form of reserve price for additional capacity, Ofgem nevertheless considers that Transco should be required to offer unsold capacity in a market that it is allowed to clear. In order to achieve this, Ofgem intends to propose modifications to Transco's licence specifying these obligations but providing Transco with discretion in choosing what that market will be provided the obligation is satisfied prior to the start of the gas day Under Ofgem's final SO incentive proposals Transco will be required to offer for sale baseline capacity levels. This obligation will be specified in Transco's Gas Transporter's licence. The capacity will be sold through a series of auctions of longer and shorter-term firm, tradable capacity rights. Under these final proposals, Transco's obligation to offer baseline capacities for sale will end at the day-ahead stage. .

The Modification Proposal

This modification proposal has been raised by Norsk Hydro (UK) and seeks to remove reserve prices for entry points, where, historically, competition is shown to exist. Under the proposal, competition at a particular terminal is assumed to exist by an excess of five active bidders.

Respondents' views

A clear majority of shippers opposed the modification proposal.

A number of respondents opposing the proposal argued that reserve prices had not contributed to distortions or influenced bid prices and levels of over-recovery. One respondent indicated that the level of over-recovery in the auctions was a result of competitive bidding at a small number of terminals and unrelated to the reserve prices.

A number of respondents argued that removal of reserve prices at competitive terminals would increase the likelihood of under-recovery. Some respondents considered that this would create uncertainty and instability in transportation charges for customers. One respondent indicated that an under-recovery would redistribute revenues from the downstream sector of the gas market to the upstream sector. A number of respondents also commented that there was a lack of clarity as to the mechanism that will be in place from April 2002 to manage any under or over-recovery.

Several respondents argued that the criteria put forward to determine whether sufficient competition exists at an entry point is arbitrary and inappropriate. One of these respondents argued that the setting of an arbitrary threshold is inappropriate and may be contrary to empirical evidence on the degree of competition at certain terminals. Another respondent said that the proposed test does not guard against the possibility that there could be, for example, one player with an 80 per cent market share and four other players bidding for the remaining 20 per cent. A number of respondents suggested using the Herfindahl-Hirschman index (HHI) rather than the suggested test.

One respondent, while opposing the proposal, did see merit in rebalancing the reserve price at less competitive terminals, such as Barrow, such that its reserve price is not set at a discount to LRMC. This respondent argued that shippers purchasing capacity at this entry point are receiving a significant discount for landing gas.

One respondent queried how the criteria would be applied. It questioned whether the intention is that each terminal would be assessed prior to the auctions, so that if there were less than five bidders in an auction, reserve prices would be reintroduced in subsequent auctions.

Another respondent argued that any reduction in capacity prices towards zero would lead to an overselling of entry capacity, increasing Transco’s level of buy-back costs.

One respondent indicated that reserve prices are not established through the Network Code and instead form part of Transco’s Charging Statement.

Several respondents sought clarification of the mechanism that will be in place from 1 April to address any under or over-recovery against allowed revenue.

One respondent argued that under the existing rules, if this modification was accepted, entry capacity secured at zero cost would share revenues from daily sales of capacity and costs of capacity buy-backs even if the buy-back action was undertaken at another ASEP. The respondent suggested that this was a significant distortion and therefore a matter for urgent discussion to determine cost apportionment.

Some respondents offered support for the modification proposal. One shipper supported the proposal on the basis that it only applied to the transitional arrangements for the next auction. It argued that the proposal would remove the artificial pricing floor that is designed for Transco’s revenue protection rather than for reasons of competition.

This respondent went on to suggest that removal of reserve prices for the summer auctions will mitigate the extent of the distortions associated with over-recoveries. A number of other respondents also supported the proposal on the basis that it would reduce over-recoveries. In this respect respondents argued that given previous over-recoveries a significant under-recovery in the next auction was unlikely.

Transco’s view

Transco opposed the modification proposal. It argued that reserve prices minimise the ability of market players to abuse market power and are set at levels aimed at avoiding distortions.

In addition, Transco argued that the measure of competition that has been proposed is inappropriate. It suggested a better measure would be the use of a concentration ratio or the HHI. Transco also commented that all entry capacity auctions to date have been highly concentrated.

Transco commented that the proposal does not specify whether it applies to the short or long-term auctions. It argued that if zero reserve prices are applied to the long-term auctions, it would be concerned that shippers may place bids below their true valuations, resulting in Transco deciding not to invest.

Transco argued that there was a risk of an under-recovery in future auctions, notwithstanding past experience. It said that the increasing volumes of capacity to be released, along with decreasing prices in successive auction rounds in the winter 2001/02 auctions, supported this view. It argued that any under-recovery would be met via an adjustment of other NTS charges, which may lead to increased instability in the level of charges.

Transco also noted that any terminals with a HHI greater than 8,000 are subject to a specific methodology aimed at minimising the potential benefits derived from market power at such terminals.

Ofgem's view

Ofgem has consistently stated its view that reserve prices should not act to withhold capacity from the market or prevent markets from clearing. However, we do recognise that reserve prices may be necessary at terminals where there is a lack of effective competition.

Ofgem therefore has in the past stated that it would welcome any move to reassess and remove reserve prices at terminals where it can be shown that there is a sufficient level of competition to mitigate the risk of collusion at a terminal. However it is important that a robust measure of the degree of competition is adopted in determining whether a reserve price can be safely removed.

In this respect, Ofgem does not believe the proposal provides for an accurate and robust measure of determining the degree of competition between shippers in the MSEC auctions and therefore shares the concerns expressed by Transco and some respondents. Under the proposal, competition is deemed to be sufficient where there is an excess of five active bidders at a terminal, thereby allowing reserve prices to be removed. Ofgem has significant concerns with this methodology, because it fails to consider the market shares of bidders. In addition, Ofgem also considers that the proposed methodology may significantly overstate the level of competition at a given terminal, particularly since a company may hold more than one shipping licence.

Whilst Ofgem does not believe this proposal should be implemented, we nevertheless will be proposing modifications to Transco's licence as part of the Ofgem's SO Final Proposals that will require Transco to offer unsold capacity in a market that it is allowed to clear. Under these proposals, Transco will be provided with discretion in choosing what that market will be, provided the obligation is satisfied prior to the start of the gas day.

Ofgem's decision

Ofgem has carefully considered the issues raised by this Modification Proposal.

While supportive of the intention underlying the proposal to remove reserve prices in auctions in which there is effective competition, Ofgem believes that the test proposed for determining whether effective competition is not sufficiently robust and therefore does not better facilitate competition. In particular, there is a risk that the application of the test could lead to the removal of reserve prices at terminals where there is insufficient competition. Ofgem does not consider that this would better facilitate the securing of effective competition between relevant shippers and suppliers.

Accordingly, Ofgem had decided not to consent to this modification, because we do not believe that it will better facilitate the achievement of the relevant objectives as outlined in Standard Condition 9 of Transco's Gas Transporters 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 New Gas Trading Arrangements