OFGEM DECISION LETTER No. 0508
"A method of Long Term Capacity Allocation"
Version 1.0

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Shippers, Transco and Other Interested Parties

Dear Colleague,

Long-term entry capacity auctions: Modification Proposals 0500 *'Long Term Capacity Allocation'* and 0508 *'A Method of Long Term Capacity Allocation'*

Ofgem has carefully considered the issues raised in Modification Proposals 0500, *'Long Term Capacity Allocation'* and Modification Proposal 0508, *'A Method of Long Term Capacity Allocation'*.

As each of these modifications concerns the structure and nature of long-term entry capacity allocations it is not possible to direct implementation of both. Having considered both modification proposals, Ofgem has therefore decided to direct Transco to implement the proposal that it considers best facilitates the achievement of the objectives outlined in amended Standard Condition 9 of Transco's Gas Transporter ('GT') licence. On this basis and against this background Ofgem has decided to direct Transco to implement modification proposal 0500 for the reasons set out in the attached paper. Ofgem has rejected Modification Proposal 0508 for the reasons in the attached paper.

Ofgem considers that Modification Proposal 0500 better facilitates the relevant objectives of the Network Code, in particular, by better facilitating the economic and efficient operation by Transco of its pipeline system and by securing effective competition between relevant shippers and between relevant suppliers. The reasons underlying our decision are set out in the attached paper.

The role of long-term auctions
Ofgem considers that long-term auctions of entry capacity, combined with Transco's entry capacity incentive, will bring about substantial improvements to Transco's investment planning process. The long-term sale of entry capacity rights supplemented by subsequent trading of entry capacity rights in secondary markets will provide Transco with a reliable indication of the demand for entry capacity at different locations on Transco's National Transmission System ('NTS'). This market related information will provide Transco with reliable and robust signals to inform its investment decisions, which when combined with Transco's entry capacity investment incentive, should facilitate efficient levels of investment and improved security of supply.

Ofgem considers that the signals obtained from long-term auctions and the subsequent trading of capacity are likely to be more robust than those obtained through Transco's existing planning process where information is provided on a voluntary basis. It should be noted in this context that in assessing Transco's proposals to offer incremental capacity for sale under the incremental capacity release process set out in Transco's GT licence, Ofgem is therefore likely to place considerable reliance upon market-delivered information.

Timing of the long-term auctions and future changes to the regime
Under modification proposal 0500, the first annual series of long-term auctions for entry capacity rights to access the NTS must be conducted by Transco in January 2003. Ofgem considers that this meets the

concerns raised by shippers that there needs to be two to three months after the publication of all relevant documents (the licence conditions, the supplementary statements and the modifications to Transco's network code) for shippers to prepare their long-term auction bidding strategies.

As was outlined in our letter to industry participants that was issued on 27 September, Ofgem considers that, subject to rapid conclusions on outstanding relevant modification proposals, no significant amendments should be made to the auction rules for the first set of long-term auctions in order to allow shippers the opportunity to prepare their bidding strategies. Therefore, while the Authority is unable to fetter its discretion regarding the consideration of future modification proposals, Ofgem does not expect to approve further significant changes to the auction rules for the auctions currently scheduled in January 2003. Ofgem however notes that modification proposals relating to both the short and long-term entry capacity regimes may be raised in the future as these regimes further develop and evolve. In this respect, whilst Ofgem considers that stability in the entry capacity regime is desirable, it is nevertheless important for participants to recognise that future changes and improvements to entry capacity regime cannot be precluded.

Approval of supplementary statements

Under special condition 27 of its GT licence, Transco is required to prepare by 1 October 2002 its procurement guidelines, and system management principles statements in a form approved by the Authority. Further, under special condition 34 of its GT licence, Transco is required to prepare and submit by 1 October 2002 an incremental entry capacity release methodology ('IECR') statement in a form approved by the Authority setting out the methodology by which it will determine whether to make incremental entry capacity available for sale to shippers.

On 27 September, Transco wrote to the Authority seeking its approval of its proposed procurement guidelines and system management principles statement. Ofgem has today written to Transco approving the form of these statements.

In addition, Ofgem has also today issued a direction under special condition 34 of its GT licence granting Transco an additional 10 days in which to submit to the Authority for approval its proposed IECR statement. Under this direction, the IECR statement must be submitted by 11 October 2002. Ofgem has indicated to Transco that it expects to be in a position to approve the form of the IECR statement shortly after this date. In addition, Ofgem has today approved the scope and objectives of the investigation to be carried out by Transco's auditors under paragraph 3 of special condition 34.

Long-term auction – summary of main features

The main features of the long-term auction are as follows:

- Quarterly System Entry Capacity (QSEC) for the period October 2004-2017 will be offered at up to 150 per cent of the System Operator (SO) baseline levels at all Aggregate System Entry Points (ASEP) as specified in Transco's GT licence;
- Shippers will be able to bid their quantities demanded for each quarter at each ASEP against reserve prices for the SO baseline levels and against a series of price increments for quantities above the SO baseline levels;
- The bidding period will last for up to ten days, with the release of information at the end of each bidding day, including the levels of demand at each ASEP at each price for each period as well as notional clearing prices;
- If these notional clearing prices at each ASEP and for every period remain unchanged over two consecutive days, the bidding period will close; otherwise it will last for ten days, with quantities bid on the tenth day being binding on shippers;
- If quantities demanded are less than or equal to the baseline quantities, Transco will allocate those quantities at the applicable reserve price;
- If demand exceeds the baseline quantities, Transco will determine whether to release incremental capacity in accordance with its IECR methodology to be established under its GT licence;

- Transco will allocate any incremental volumes of capacity at common clearing prices for each ASEP and each period. Where demand is equal to the volume available at the selected cleared price, then capacity will be allocated to all valid bids at that price. In the event that demand is greater than the volume available at a particular price but insufficient for the market to clear at the next highest incremental price then capacity would be allocated at this latter price, which is the lowest price step at which demand is less than supply. Any unallocated capacity at this price will be made available in subsequent allocations.

The details of the long-term auctions are described in the attachment and are set out fully in Transco's legal text to implement this proposal. Shippers should examine the legal text of the Network Code and should not rely on any descriptions of the processes established by modification proposal 0500 that are contained in this letter.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number. Alternatively, you may contact Lyn Camilleri on 020 7901 7431 or Chris Hemsley on 020 7901 7340.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements

Ofgem view on modification proposals 0500 and 0508

Background
This paper describes the background to each of these modification proposals and summarises the modification proposals. The paper also summarises the responses received to the consultations on each modification proposal and outlines Ofgem's view.

The New Gas Trading Arrangements

On 1 October 1999, following a period of over two years of consultation, the New Gas Trading Arrangements (NGTA) were implemented in Great Britain, including a revised entry capacity regime, consisting of:

- an efficient, non-discriminatory method of selling firm entry rights to the NTS related to the physical capacity available. This was achieved through the introduction of price auctions for the sale of entry capacity; and
- a regime that gave Transco appropriate commercial incentives to maximise the availability of capacity.

These changes to the entry capacity regime addressed short-term availability and allocation issues, but did not provide any long-term mechanism for the provision of capacity. Neither did they address the question of the long-term signals and incentives for investment in the NTS.

In response to concerns raised by the gas industry and customers about the importance of shippers being able to purchase capacity several years ahead of use and the need for improved long-term investment signals and incentives on Transco to invest in response to changing demand and supply patterns, Ofgem outlined its commitment to undertake a review of the existing arrangements Concerns about long-term investment in the NTS originally stemmed from severe capacity shortages that occurred during the summer and autumn of 1988. The concerns were exacerbated by increasing evidence of NTS constraints, most notably at the St. Fergus terminal in summer 2000 and again in autumn 2000.. This review was initiated in 1999 and completed in March 2001.

Long-term investment consultation and Ofgem's proposals

Ofgem undertook a series of consultations with shippers, Transco and other interested parties in order to develop a set of proposals for developing signals and incentives for long-term investment in the NTS *'Long-term signals and incentives for investment in transmission capacity on Transco's National Transmission System: A consultation document'*, Ofgem, May 2000; *'Long-term signals and incentives for investment in transmission capacity on Transco's National Transmission System: Conclusions on the framework'*, Ofgem, December 2000; and *'Long-term signals and incentives for investment in transmission capacity on Transco's National Transmission System: The new regime',* Ofgem, March 2001..

Ofgem proposed that as part of this long-term framework, there should be auctions of longer-term capacity rights combined with financial incentives on Transco to invest in the NTS. Ofgem considered that the price signals emerging from the primary and secondary markets would provide Transco with valuable additional information that would assist it in planning efficient network expansion and responding to changing patterns of supply and demand. Under the proposed framework the development of Transco's incentives was to be taken forward in parallel with Transco's price control for April 2002-7. In this respect, it was proposed that Transco be set allowed revenues under its price control combined with associated entry capacity output measures. Under the proposals, Transco would be able to keep a proportion of the additional revenue associated with delivering incremental capacity above the agreed output measures but would have an exposure to buy-back costs that resulted from any failure to deliver on these outputs. The proposals envisaged that Transco would be obliged to offer for sale at least the output measures by way of a series of long and short-term auctions.

In setting out its conclusions, Ofgem rejected arguments for the sale of long-term capacity rights through bilateral contracts on the grounds that such arrangements would be inconsistent with Ofgem's and Transco's duties to promote competition and avoid undue discrimination.

Ofgem's conclusions on the appropriate reforms to the long-term entry capacity regime were incorporated into Ofgem's initial proposals for Transco's System Operator ('SO') incentives which were released in September 2001 *Transco's National Transmission System – System Operator incentives 2002-7 – Initial proposals*, Ofgem, September 2001.. The review of Transco's SO incentives formed part of the periodic review of Transco's price control, scheduled to take effect on 1 April 2002.

SO Incentives – Ofgem's final proposals

In December 2001, Ofgem issued its final proposals on Transco's SO incentives *'Transco's National Transmission System – System operator incentives 2002-7 – Final proposals'*, Ofgem, December 2001.. In this document, Ofgem set out its proposed framework for the introduction of financial incentives on Transco to invest in NTS entry and exit capacity where it is efficient to do so in response to its customers' changing needs. Ofgem also set out proposals to improve the incentives on Transco to carry out its day-to-day role of operating the NTS economically and efficiently.

Ofgem proposed, as part of Transco's price control for the period April 2002 to 2007, that Transco would be provided funding to cover the efficient level of operating and capital expenditure required to provide agreed baseline levels of NTS entry capacity – known as the Transmission Asset Owner ('TO') baseline entry capacity output measures. Ofgem proposed that the baseline outputs be set at the maximum physical capacity levels for each entry point to the NTS.

Under Transco's SO incentives, Ofgem proposed that Transco be required to offer for sale 90 per cent of the TO output measures – the 'SO baseline volumes' – through a series of auctions of longer and shorter-term firm, tradable, capacity rights. The SO baseline volumes of capacity were made available to shippers in the February 2002 short-term entry capacity auctions for the period 1 April 2002 to 30 September 2002 and in the August 2002 auctions for the period 1 October to 31 March 2003.

The proposed SO incentive framework provided for an entry capacity investment incentive that allowed Transco to earn higher returns on additional investment than its regulated cost of capital, set in the TO price control at 6.25 per cent. Under the SO entry capacity investment incentive, it was proposed that Transco could earn a return of up to 12.25 per cent from sales of incremental entry capacity for a rolling five year period from the date when the capacity is delivered. In addition, if revenues from the sale of extra capacity were insufficient to cover the depreciation and financing costs of additional investment, it was proposed that Transco's downside exposure would be limited to 5.25 per cent.

Modifications to Transco's GT licence

On 27 September 2002, Ofgem issued a direction under section 23 of the Gas Act 1986 to modify Transco's GT licence to implement the SO incentives and the TO price control. This direction followed two statutory licence modification consultations on the Transco price control in April and August 2002 respectively.

The licence modifications require Transco to offer for sale the SO baseline volumes and any additional obligated incremental entry capacity volumes that Transco is required to release following the application of its Incremental Entry Capacity Release ('IECR') methodology. Under Special Condition 34 of Transco's GT licence, Transco is required to prepare and submit an IECR methodology statement, in a form approved by the Authority, setting out the methodology by which it will determine whether to make entry capacity in addition to the SO baseline volumes available for sale to shippers.

A decision by Transco to make available incremental capacity should be made in response to the signals provided by the primary auctions of capacity, and the secondary trading of that capacity. The decision may also be influenced by the outcomes of Transco's existing planning processes. The licence conditions provide for Transco to apply to the Authority to release obligated incremental capacity as a result of the application of its IECR methodology in return for Transco obtaining the benefits of revenues from such capacity being included within the entry capacity incremental investment incentive. Transco may make a proposal to Ofgem for incremental capacity to be released and treated as obligated under the incremental entry capacity investment incentive licence provisions. If all of the criteria set out in the IECR have been met, Transco may choose to make available incremental entry capacity as obligated capacity to obtain the benefit of its investment incentive, with this decision being subject to review by Ofgem under the provisions of Transco's GT licence.

Under the licence modifications, both the SO baseline volumes and any obligated incremental capacity must be offered for sale in at least one allocation that is allowed to clear This obligation is expressed to be subject to the provisions of amended standard condition 4 of Transco's GT licence.. In addition to this minimum level of capacity ('obligated capacity'), Transco will be able to sell additional incremental capacity ('non-obligated capacity'), with the revenues from these sales being included within its buy-back incentive performance measure.

In addition, Transco will be obliged to offer no more than 80 per cent of the initial obligated capacity in long-term allocations, with the remaining 20 per cent being reserved for short-term allocations.

The licence modifications also provide for the treatment of unpaid liabilities arising from a shipper failure. In such circumstances, Transco is required to re-offer any obligated capacity for sale in a clearing allocation. The licence modifications also enable Transco to apply to Ofgem for the declaration of an Income Adjusting Event ('IAE').

In addition to the IECR statement, the licence amendments require Transco to develop a number of supplementary statements, including:

- Procurement Guidelines
  Detailing the kinds of system management services which Transco is intending to procure to assist it in managing the system together with an outline of the procurement mechanisms by which it intends to acquire those services. The form of Transco's Procurement Guidelines was approved by the Authority today (30 September 2002) under special condition 27 of Transco's GT licence.
- System Management Services Adjustment Data Methodology
  The purpose of this methodology is to define how the costs incurred by Transco in procuring system management services outside its current range of tools will be included in its network code charges so as to ensure that these costs are appropriately targeted.
- System Management Principles Statement
  Setting out the principles and criteria by which Transco will determine which system management services it will use to manage the system. The form of Transco's System Management Principles Statement was approved by the Authority today (30 September 2002) under special condition 27 of Transco's GT licence.

Timing of the commencement of long-term auctions

Ofgem's letter of 6 September 2002 explained that the first set of long-term auctions would take place in January 2003. Therefore, following the implementation of the modifications to Transco's GT licence as described above, Transco is now required to use all reasonable endeavours to conduct the first long-term auctions by 1 February 2003. This allows a period of approximately three months after finalisation of Transco's GT licence and supplementary statements, as well as the auction rules, until the auction is held. Shippers have indicated that this provides a sufficient period of time for them to develop their understanding of the new entry capacity regime and formulate their bidding strategies for a January 2003 long-term entry capacity auction.

Short-term auctions – general background

Transco has allocated monthly system entry capacity (MSEC) rights to access the NTS via six monthly entry capacity auctions since September 1999. The most recent set of auctions for the period 1 October 2002 to 31 March 2003 were completed in August 2002.

Currently MSEC is allocated over four rounds, with 25 per cent of the available capacity offered in each round with any unsold capacity from the first three rounds being offered for sale in the fourth round. In addition, any unsold entry capacity after the four rounds is made available as an 'off-the-shelf' product, which is sold on a first-come, first-served basis at a fixed price. 'Off-the-shelf' capacity is available from the time after Transco announces the allocations of MSEC until and including the fourth day before the first day of the month for which the application is made.

In addition, Transco holds auctions of daily firm system entry capacity ('DSEC') on a day-ahead and within-day basis. Transco also releases a use-it-or-lose-it ('UIOLI') interruptible capacity product on a day-ahead basis. This product is intended to prevent the hoarding of firm entry capacity by shippers. The volumes of UIOLI capacity are determined as the amount by which the holdings of firm entry capacity exceed Transco's estimate of aggregate nominated flows at each terminal.

Capacity period

The provisions of Transco's network code originally envisaged that the third set of MSEC auctions, held in August 2000, would allocate entry capacity for a twelve-month period (1 October 2000 to 31 September

2001). However the capacity period was subsequently shortened following Ofgem's acceptance of modification proposal 0409, '*Review to monthly auction capacity parameters'*.

In addition, the network code envisaged that the August 2002 auctions should provide for a 12-month allocation of entry capacity. However, this period was shortened to six months following Ofgem's acceptance of modification proposal 0564, *'Amendment to period of summer capacity auctions to six months'*.

Timing of short-term auctions

Following the implementation of modification proposal 0564, the next short-term auctions of MSEC will cover the six-month period of 1 April 2003 to 30 September 2003. These auctions are scheduled to be completed by 28 February 2003.

Capacity management and entry capacity buy-backs

If expected flows onto the system exceed both the capability of the system at an entry point and the amount of capacity held by shippers at that terminal, Transco must act to reduce the amount of available capacity. In the first instance, this is achieved through the scaling-back of interruptible capacity. Transco must then purchase firm entry capacity rights ('buy-back capacity') at market-determined prices, until expected flows can be accommodated by the available capacity rights. To this end, Transco is now free to contract for capacity ahead of the gas day, by entering into forward and option contracts for entry capacity, with a view to reducing the total costs of capacity management.

Transco has financial incentives efficiently to manage the costs of entry capacity buy-backs. Under these incentives (included in its GT licence), Transco faces a £35 million annual target level for the period 1 April 2002 to 31 March 2003. Transco is rewarded for performance below target and penalised for performance above target. Transco's possible revenues and costs under this incentive are subject to a cap of £30 million and a collar of £12.5 million.

Overrun charges

One of the key features of the NGTA regime is the 'ticket to ride' principle for entry capacity. Entry capacity overrun charges are levied on shippers who flow gas without securing sufficient volumes of entry capacity. This is designed to give shippers strong financial incentives to purchase capacity before flowing gas. The current overrun charge is set equal to the higher of:

- 1.1 times the weighted average price by volume of the top 25 per cent accepted bids for daily capacity;
- 1.1 times the highest accepted buy-back price; and
- 8 times the daily rate for monthly system entry capacity (based on the weighted average price of the top 50 per cent of bids accepted in the monthly auction).

Today, AEP has raised modification proposal 0589, '*Revisions to entry capacity overrun charges ahead of next auctions'*. This proposal would change the multiplier applied to MSEC capacity from 8 to 1.1 and, if implemented, would have effect from 1 April 2003.

Entry capacity neutrality arrangements

Net entry capacity management costs are recovered through capacity neutrality charges which, following Ofgem's acceptance of modification proposal 0559 *'Changes to buy-back liabilities',* are levied on shippers based on their end of day holdings of entry capacity.

Modification Proposal 0500, 'Long Term Capacity Allocation'

On 12 November 2001, Transco raised modification proposal 0500, which was then developed during a series of workstream discussions. Transco submitted its workgroup report to the modification panel on 11

January 2002. Following the submission of this report the workstream continued to debate and develop the modification, resulting in a number of revisions to the proposal.

The proposal was sent for consultation on 8 February 2002, which closed on 10 June 2002.

Original modification proposal

The main features of the original proposal were as follows:

- Transco would offer entry capacity for a period up to 13 years in advance of the time of use;
- Quarterly System Entry Capacity (QSEC) would be offered from year 4 to year 13 in annual auctions held in July;
- MSEC would continue to be offered on an annual basis for years 1 to 3 in a one-round pay-as-bid blind auction, and thereafter in annual allocations;
- MSEC would be offered from a month in advance of the relevant month up to and including year 3 (‘rolling MSEC’ or RMSEC);
- DSEC would be offered from the day before through to 2:00am on a relevant gas day;
- DISEC would be offered on the day ahead of a relevant gas day;
- The quantities of capacity offered would be no less than the baseline quantities specified in Transco’s GT licence, with 80 per cent of SO baseline capacity offered initially in the most distant year for which capacity is made available and residual quantities made available in subsequent allocations. The 20 per cent of SO baseline capacity would be offered in the year immediately preceding the relevant gas year. Transco would be able to offer additional quantities in any allocation;
- QSEC would be offered in a bid period of five business days during which shippers would be able to bid their quantities demanded at each price;
- Transco would signal an initial cost associated with the baseline quantities, as well as a series of 20 marginal costs broadly reflecting the costs associated with providing increments of capacity above the baseline levels;
- At the end of the bid period, Transco would aggregate the quantities demanded to construct demand curves for each period;
- If aggregate demand is less than or equal to the baseline outputs at the initial price, all capacity demanded would be allocated at that price;
- If aggregate demand is more than the baseline outputs at the initial price, Transco would consider whether to release additional capacity and would then determine a cleared price and volume to be allocated; and
- If demand is equal to the volume to be made available at the selected clearing price, then capacity would be allocated to all valid bids at that price. If demand exceeded supply at the cleared price, then Transco would allocate 100 per cent of users’ demand at the next price step at which aggregate demand is less than supply. The remaining unallocated capacity would be allocated in proportion to the extent of users’ unsatisfied demand at the cleared price (‘the pro-rating mechanism’).

During the consultation period a number of changes were made to Modification Proposal 0500, to incorporate some elements of Modification Proposal 0508, which is an alternative proposal for long-term auctions raised by TotalFinaElf UK plc (and discussed in more detail later in this document). These included changing the period over which long-term capacity would be sold from years 4 to 13 to years 3 to 15, releasing information concerning aggregate bid volumes at the end of each bidding window, and introducing the possibility of an early closure should bids remain unchanged between rounds. These changes are discussed in more detail below.

On 2 July 2002, Transco issued a supplementary consultation which sought views on a proposal to remove the pro-rating mechanism that ensured that demand exactly matched the available capacity and replaced it with provisions to cascade any unallocated capacity to subsequent allocations. This proposal was incorporated into the final modification and is described below.

In addition, Transco implemented a number of changes to the modification proposal in light of the responses received to the consultation. In particular, Transco originally included provisions to cancel capacity rights in the event that a Competent Authority found them to be contrary or incompatible with any legal requirement. Further, it was proposed that the volume of UIOLI interruptible capacity made available at the day-ahead stage would be capped to the greater of 100GWh/d and 10 per cent of the SO baseline capacity volumes. Both of these elements have been removed from the proposal.

In response to Ofgem's letter of 6 September 2002 in relation to the timing of the long-term entry capacity auctions, Transco issued a further supplementary consultation on its proposal to amend its Final Modification Report to provide that the first long-term auction would be held in January 2003.

Final modification proposal

Allocation mechanisms

The final version of modification proposal 0500 proposes to allocate capacity in the following manner:

- Capacity would be initially offered as QSEC for years 3 to 15 with year 3 commencing on 1 October 2004. The first QSEC allocation is due to commence in January 2003, selling capacity for the period from October 2004 to September 2017. Subsequent annual auctions would be held in August, offering capacity for years 3 to 15 relative to that particular year;
- Transitional arrangements apply for the sale of capacity relating to years 1 and 2 (i.e. 2002/3 and 2003/4). This capacity will be offered as MSEC in pay-as-bid auctions held over four rounds. The capacity for 2002/3 will be sold in accordance with Modification Proposal 0564 *'Amendment to period of Summer Capacity Auctions to Six Months'* Ofgem accepted modification proposal 0564 on 19 July 2002, which provides for an allocation of capacity covering the period April to September 2003, to be completed by 28 February 2003*,* in two six-monthly allocations. 2003/4 capacity will be offered in one allocation to be held before 31 August 2003;
- MSEC would be offered on an annual basis in a one-round pay-as-bid blind auction in August;
- Capacity would subsequently be made available as RMSEC, offering monthly capacity at no greater than five days prior to the start of the month of use;
- DSEC would be offered from the day before through to 2:00am on a relevant gas day;
- DISEC would be offered on the day ahead of the relevant gas day; and
- The quantities of capacity offered would be no less than the SO baseline quantities specified in Transco's GT licence, with 80 per cent of the SO baseline capacity offered initially for the most distant years for which capacity is made available and residual quantities being made available in subsequent allocations. The 20 per cent of SO baseline capacity would be offered in the year immediately preceding the relevant gas year. Transco would be able to offer additional quantities in any allocation.

Allocation of the long-term product

Bidding process and information release

Transco will specify in its IECR statement, reserve prices at each ASEP that will apply to the volumes of obligated capacity available at that allocation. Also included within its IECR statement will be a schedule of 20 prices at each ASEP that correspond to an estimate of the costs of expanding capacity to 20 equal volume increments from 100 per cent to 150 per cent of the SO baseline volumes.

Bidders will then submit bids indicating the volume of capacity that they wish to secure at each of the price steps. These bids will be submitted over a period of 10 days covering all ASEPs. At the end of each day, Transco will publish the aggregate volumes bid at each price level for each ASEP and quarter.

At the end of each day, Transco will calculate the lowest price at which supply exceeds demand for each ASEP. If these prices at all ASEPs and for every quarter remain unchanged between two successive days then the allocation process will close. In the absence of such an early closure, the bidding will continue up to and including the tenth day.

Allocation mechanism

At any terminal, in any period where demand is less than the minimum volume of capacity being offered, capacity will be allocated to all of the valid bids submitted at the reserve price and bidders will pay that reserve price.

Where demand exceeds the minimum volume of capacity being offered at the reserve price, the volume of capacity to be allocated will be determined by Transco's IECR methodology.

Transco initially proposed that the cleared price be set as the highest price at which demand exceeded the volume of capacity to be allocated. Capacity would then be allocated to the volume bid at the next highest price, with the excess demand scaled back in proportion to the unsatisfied demand at the clearing price.

Following a supplementary consultation, this process was replaced by one in which the cleared price for each ASEP in each quarter is set as the lowest price at which the volume of capacity to be allocated is less than supply. Any unsold capacity would then be available in subsequent allocations.

Transco will inform users of their allocations of capacity no later than two months after the allocation process.

The final modification proposal provides for the pro-rating of bids if there is no price at which demand is less than supply. In such circumstances, the cleared price will be set equal to the highest price in the price schedule. Shippers' demand at that price will then be pro-rated, such that demand is equated to the volume of capacity being made available.

Allocation of the short-term products

Annual MSEC allocations

Following the transitional period relating to capacity for the years 2002/3 and 2003/4, Transco proposes to offer for sale capacity relating to between 1 and 2 years prior to the period of use as MSEC. The volume of capacity offered will include any unsold baseline capacity and obligated incremental capacity from the QSEC allocations, any discretionary incremental capacity and (in the case of the allocation one year ahead of the period of use) any capacity that has been held back for release in the short-term in accordance with Transco's GT licence.

It is proposed that this allocation be operated in a similar manner to the existing MSEC allocations, but held over a single auction round. As such, the allocation will be a blind, pay-as-bid allocation.

RMSEC allocation

Transco proposes that prior to the commencement of each month there will be a one round, blind, pay-as-bid allocation. Transco will make available any unsold obligated capacity from previous auctions plus any discretionary non-obligated capacity. This would replace the existing off-the-shelf capacity allocation process.

DSEC allocation

Shippers will be able to apply for DSEC from the day-ahead stage and during the gas day. Capacity allocated during the gas day will be on the basis of an equal maximum hourly use throughout the remainder of the gas day.

DISEC allocation

UIOLI capacity will be made available at the day-ahead stage, in the form of DISEC.

Capacity volumes

Transco proposes that the total volume of capacity offered in the allocations will be equal to the entry capacity SO baseline output measures, which are specified in Transco's GT licence. Initially, 80 per cent of this capacity will be made available in the QSEC allocations. Any unsold capacity will be made available in subsequent QSEC, MSEC or RMSEC allocations. In addition, in the MSEC allocation occurring immediately prior to the commencement of the gas year the remaining 20 per cent will also be made available. Transco will also be able to offer incremental entry capacity in any of the capacity allocations.

Credit arrangements

Transco has proposed to include within a shipper's calculated indebtedness the liabilities associated with the following 12 months of capacity holdings. Transco would be able to reject bids for capacity rights where a shipper's credit exposure was in excess of 85 per cent of their credit limit.

As currently provided for in Transco's network code, the payment liability would remain with the original purchaser of the capacity right, irrespective of any secondary trading and Transco would have the ability to recall capacity upon termination of a shipper as a user of its network code.

Overrun charges

Overrun charges would continue to apply to shippers flowing gas in excess of their capacity holdings. The calculation of the charge would be amended to include entry capacity secured in QSEC, RMSEC and MSEC allocations and would be set equal to the higher of:

- 8 times the highest price paid for entry capacity in any allocation of firm entry capacity relating to that gas day;
- 1.1 times the weighted average price by volume of the top 25 per cent of offers for entry capacity buy-backs accepted during the gas day;
- 1.1 times the weighted average price by volume of the top 25 per cent of offers for entry capacity buy-backs accepted prior to the commencement of the gas day;
- 1.1 times the weighted average price by volume of the top 25 per cent of the exercise prices of capacity option contracts entered into by Transco.

Respondents' views

There were eighteen respondents to the consultation. The majority of respondents opposed the initial modification proposal 0500. A number of respondents expressed their support for the principle of long-term entry capacity auctions. In particular, respondents supported the concept that this will allow shippers to secure capacity rights well ahead of the period of use and provide information to Transco, better enabling it to respond under its entry capacity incentives.

The respondents offering qualified support did so citing reasons including the number of uncertainties in the regime, the need to further develop the modification proposal and the timing of the introduction of the first long-term auction.

Of the respondents opposing the proposal, two did so on the basis that they opposed the use of auctions to allocate entry capacity. Some respondents also cited the withholding of a proportion of the available capacity for the short-term allocations, the timing of the first long-term allocation and the fact that the proposal was not sufficiently complete.

Allocation mechanisms

A majority of the respondents who commented on the appropriate duration for the long-term auctions offered support for a long-term release from years 3 to 15 inclusive, with a short-term release covering years 1 and 2.

Allocation of the long-term product

Definition of the product

The majority of respondents offered support for the sale of a quarterly capacity product. Reasons cited as justification for such a release included that QSEC will:

- enable shippers to secure a seasonal profile of capacity, even in the absence of a secondary market;
- provide Transco with seasonal (and peak) demand signals, avoiding the need for Transco to make assumptions about market demand, and
- match the frequency of gas supply contracts.

Bidding process and information release

Of the respondents that commented on the length of the bidding period, a majority offered support for a ten day bidding window. One commented that a lengthy allocation period was particularly necessary in the first allocation.

A majority of the respondents commenting on the proposal to release information during the auction offered support. In particular, respondents indicated that information release will enable bidders to revise bids, facilitate the matching of supply and demand. Other respondents indicated that it would lead to a more efficient allocation and improve the investment signals provided to Transco.

A number of respondents raised concerns about the information release process. One respondent suggested that the information release would not make any difference to bidding behaviour and that the resulting signals would not be reliable. Another stated that the process should not penalise bidders who alter their volumes but who are unable to keep the allocation open.

All of the respondents that expressed an opinion on the appropriate price steps offered support for the proposal to calculate prices on the basis of the cost of providing incremental capacity from the SO baseline level to 150 per cent of the SO baseline level, in 20 equal volume increments.

Allocation mechanism

A number of respondents specifically offered support for a volume based allocation, with one respondent arguing that it is better suited to deliver cost-reflective prices and is less susceptible to price increases driven by sentiment, when compared to a pay-as-bid allocation.

Respondents commented on the interactions between the allocation process and the IECR methodology. A small number of respondents stated that the proposed two-month delay between the closure of the bidding window and the firm acceptance of bids was too long and that there was a lack of clarity surrounding the allocation process.

There were only seven responses to the supplementary consultation on the removal of the pro-rating mechanism. While the majority of these respondents did not support the proposed change, one respondent suggested that the pro-rating aspect of the allocation mechanism should be removed because the effect of the rule is to cause over-bidding to ensure that shippers secure capacity. One respondent, while suggesting that the proposal could result in slightly less efficient investment, also suggested that, from an efficient investment perspective, the proposal would provide certainty for shippers, as they would get the volume they demanded at the cleared price.

Following the supplementary consultation, one further respondent offered support for the removal of the pro-rating at the cleared price, stating that the proposal should avoid any distortions during the allocation process.

A number of respondents did not consider the original pro-rating mechanism to involve significant distortions, because the outcomes were unpredictable.

The respondents offering support for the original proposal argued that the revised proposal was not cost-reflective and would enable Transco to escalate the price paid for capacity by allocating capacity just below the level of demand, thereby increasing the likelihood of revenue over-recoveries.

Timing

Respondents also raised concerns about the timetable for the commencement of the long-term allocations, suggesting a number of potential dates ranging from October 2002 to 2004. Respondents also argued that it was important to have a sufficient period between the finalisation of the licence and associated documents and the commencement of the auctions, suggesting periods of two and three months would be appropriate.

There were 10 responses to Transco's supplementary consultation on the timing of the first long-term auction. The majority of respondents supported a delay in the timing of the auction, with some respondents qualifying their support for Transco's proposal of January 2003.

Allocation of the short-term products

Annual MSEC allocation

A number of respondents commented on the design of the annual MSEC allocation. Concerns were raised about the use of one round to allocate all of the available capacity, particularly for the period October 2002 to September 2004, when all capacity would be offered in short-term auctions. One respondent stated that a one round auction would put pressure on new entrants and those shippers who failed to secure capacity in the long-term auctions, resulting in higher capacity prices. However, one respondent specifically supported the use of a one round allocation, due to the frequency of bidding opportunities for shippers.

RMSEC allocation

A majority of respondents commenting on the replacement of the off-the-shelf allocation with the RMSEC allocation offered support. A number of these stated that the allocation should occur close to the start of the month of use. One respondent commented that the RMSEC allocation would align all of the allocation processes.

However, one respondent offered support for the retention of the off-the-shelf allocation, on the basis that it allowed shippers to secure capacity prior to five days before the start of the relevant month. Another respondent raised concerns about the administrative burden of the RMSEC allocations.

DISEC allocation

A small number of respondents commented on the continuation of the UIOLI anti-hoarding provisions, with all offering support for its continuation.

Capacity volumes

There were concerns as to whether any capacity should be reserved for release in short-term allocations. A number of respondents were opposed to any reservation, arguing that this would reduce the clarity of the investment signals, stifle the development of the secondary market and have an inflationary effect. One respondent also argued that new entrants' requirements could be secured through the secondary market and would have been included within the traditional planning processes. A respondent suggested that capacity for new entrants should be provided as incremental capacity.

Two respondents commented on Ofgem's intention to review in two years the need for the obligations to reserve 20 per cent of the SO baseline capacity for the short-term, arguing that this creates uncertainty.

Those respondents supporting the proposal cited the need to prevent foreclosure of the market and the creation of barriers to entry. One respondent also stated that the proposal would give certainty to those shippers who were unwilling or unable to secure long-term capacity.

Credit arrangements

A number of respondents were concerned that the proposed credit arrangements are not strong enough and expose shippers to too much risk of bearing the losses caused by a defaulting shipper. Respondents also commented that Transco should undertake a review of a shipper's credit provisions more frequently than the current annual evaluation, with one noting that the proposed arrangements would result in low barriers to entry but a high risk of exposing shippers to default costs. Another added that it was unclear whether the credit arrangements would be sufficient when a shipper rapidly lost its credit rating. One respondent stated that Transco should face incentives to manage the credit arrangements, by facing a proportion of the costs of any shipper default.

Determination of overrun charges

One respondent opposed the proposal to amend the determination of the overrun charge, arguing that it should be set in a cost-reflective and not penal manner.

Other issues

Buy-back cost apportionment

One respondent specifically commented on the appropriate method to recover buy-back costs incurred by Transco, arguing that recovering these costs through capacity holdings makes the capacity rights more difficult to price and weakens the investment signal in the primary auctions. It argued that the SO commodity charge should be used where there are shared buy-back liabilities.

Cancellation of capacity rights

Most respondents commented on Transco's proposal to include provisions providing for the cancellation of capacity rights upon the determination of a competent authority, opposing its inclusion. However, one respondent offered support for some form of provision. Respondents opposed to the proposal indicated that the provision would undermine the firm nature of the long-term capacity rights, had not been discussed and was inconsistent with the business rules.

Transco's views

Transco supports the principle of making available longer-term entry capacity rights and states its belief that, taken together with the proposed SO incentives, this proposal should better enable Transco and users to contract for an efficient level of entry capacity. In its opinion, the proposal better facilitates the relevant objectives of the efficient and economic operation by the licensee of its pipeline system and the securing of effective competition between relevant shippers and between relevant suppliers.

The key features of the proposal which Transco believes will help achieve these relevant objectives are:

- Long-term capacity allocation will enable contracting for an efficient level of entry capacity that will satisfy users' needs and could be offered at prices that reflect Transco's costs;
- Users will be able to signal their seasonal demand, supplementing the present planning process;

- Offering long-term capacity to all users on a non-discriminatory basis and utilising credit arrangements that maintain low barriers to entry will enhance effective competition; and
- A frequent offering of capacity will reduce the risks faced by users and provide them with greater certainty. This will enable users to incrementally manage a portfolio of capacity rights covering a variety of periods of time.

Transco notes as disadvantages of the proposal that more complex systems are required to manage the entry capacity process and that a long-term capacity release may create 'considerable inertia' to change should refinements be necessary.

Allocation mechanisms

Following Transco's supplementary consultation on the timing of the first long-term auction, Transco proposes that the first long-term auctions be held in January 2003.

Transitional arrangements

Transco makes reference to the outcomes of Modification Proposals 0549, *'Summer 2002 Capacity Auction'*, and 0564, *'Amendment to Period of Summer Capacity Auctions to Six Months'*, which provides that entry capacity for the period 2002/03 is offered in two six-monthly auctions which will consist of four auction rounds. It also indicates that modification proposal 0500 provides for the initial release of capacity for the gas year 2003/04 to be conducted over four rounds.

Allocation of the long-term product

Definition of the product

Transco considers that the long-term capacity product should be a quarterly product. It states that a quarterly product potentially provides valuable signals about seasonal requirements that would not be available through an annual product and would provide an opportunity for a more efficient capacity provision.

Duration of sale

Transco notes the support from respondents for its revised proposal to offer capacity for years 3 to 15.

Bidding process and information release

Transco believes that the marginal cost steps against which shippers will bid volumes demanded should be small enough to offer an opportunity for a close match between supply and demand. In response to support expressed by respondents to 20 price steps, Transco proposes to proceed on this basis. It expects that the price steps, and the approach to their calculation, will be specified in its IECR. Transco expects that the price steps will reflect estimated long-run marginal costs.

Transco notes that, following development in the workstream, the bid period for QSEC was increased from 5 days to 10 days, with the possibility for early closure if the clearing price is stable day-on-day. It notes the level of support for a 10-day bid period and believes that, in conjunction with the proposed closure rules, the proposal provides an appropriate opportunity for users to rapidly refine their positions in the light of emerging signals. It considers that a day between each bid window would expand the auction process to one month, which it would not support.

Transco believes that the publication of an end-of-day snapshot, rather than real time data, will minimise the gaming opportunities created by the information release. It states that bidders cannot be certain to what extent competitors will amend their bids and considers that potential gaming is limited. Transco states that if inappropriate behaviours are revealed, that could be an issue for Ofgem's consideration and recognises that the close-out process could evolve further in light of future experiences and subject to an appropriate network code modification proposal being raised.

In response to one respondent's concern about the minimum bid quantity, Transco considers that, while this may have been a significant issue under the original proposal, the changes made removing the pro-rating element from the allocation rules mean that this is likely to have a far more limited impact. Transco does not therefore consider that it is appropriate to change this requirement at this late stage of system development.

Allocation mechanism

Transco states that there has been some concern expressed during workstream development about the extent and effects of pro-rating and that one aspect of modification proposal 0508 was to seek to remove any pro-rating effects. Transco believes that the allocation mechanism described in the supplementary consultation should be incorporated because it will provide a non-discriminatory clearing mechanism with the whole of the allocation process based on bidders' valuations rather than pro-rating.

In response to respondents' concerns about the time delay between the close of the auction bidding window and notification by Transco of the results of the auction, Transco indicates that it plans to publish information as soon as it is able to, but stated that the time required is uncertain. Transco states that it will need to analyse the bids received, reach views on the capacity offers to accept, seek internal approval for any associated expenditure and seek approval from Ofgem through the IECR process, including commissioning an audit of its application of the IECR.

Allocation of the short-term products

Annual MSEC auctions

Transco considers that the increased number of opportunities to obtain entry capacity, through a series of annual and within-year processes, will effectively provide a multi-round opportunity for users to obtain capacity, even though there will be a single bid day for the annual MSEC auctions. Transco states that in the context of the series of auctions, the quantities made available in the annual MSEC auctions may be comparatively small and it believes that a single day bid period should be sufficient.

RMSEC

Transco considers that competition between users and the efficient allocation of capacity may best be served by implementing the RMSEC allocation as a replacement of the current off-the-shelf allocation. Transco notes that the RMSEC allocation process will provide an additional opportunity for Transco to respond to demand for additional entry capacity. It states that the RMSEC auctions will occur within five business days of the end of each month.

DISEC

While Transco originally proposed limiting the quantities of DISEC that it would make available, to the greater of 10 per cent of baseline capacity or 100 GWh, it decided not to pursue this proposal because of the widespread shipper and Ofgem support for the continued release of potentially high quantities of interruptible capacity. However, in its opinion, a release of a high level of interruptible capacity could potentially lead to the inefficient operation of the system and a high degree of uncertainty for users about the extent of scale back. It considers that the requirement for an anti-hoarding mechanism is reduced because the baseline capacity is generally greater than physical capability.

Capacity volumes

Transco states that it expects, at a minimum, to accept all valid bids for capacity up to the level of long-term NTS SO baseline entry capacity as defined in Ofgem's proposed (at the time) amendments to Transco's GT licence (i.e. 80 per cent of the SO baseline entry capacity quantities in Table A2 of Transco's GT Licence). Transco anticipates publishing a revised Transportation Statement at least 28 days before any auction, as specified in the proposal.

Transco indicated that it expected the minimum quantities of capacity it must make available for sale to be specified in its GT licence and believed that concerns about the definition of this quantity to be a matter for Ofgem to consider in light of responses to its consultation on proposed (at the time) amendments to Transco's GT licence.

Credit arrangements

Transco states that it has tried to strike a balance between credit arrangements that would create prohibitive cost for some who may otherwise wish to take part in the long-term auctions and weak arrangements that enable any costs of failure to be passed on to other users. Transco believes that a twelve-month capacity credit requirement is the maximum term of credit guarantee that can be obtained without recourse to bespoke (therefore expensive) products.

Overrun charges

Transco argues that it is necessary for the overrun charge to reflect all of the types of capacity product, including QSEC, forwards and options. It argues that it has not tried to adjust significantly the level of charges, but rather to extend the scope of the calculation so that it reflects the prices associated with all forms of capacity and capacity management tools. Transco suggests that a review of overrun charges can be conducted through the usual channels.

Other issues

Buy-back cost apportionment

Transco believes that any proposals to substantially change the present capacity neutrality arrangements should be the subject of a separate network code modification proposal. It states that Ofgem has proposed and consulted on parameters for a buy-back incentive scheme and these fall outside the remit of this modification proposal.

Information provision

Transco repeats its opposition to the release of maintenance information prior to the commencement of an auction. However, Transco has amended the legal text of modification proposal 0500 to reflect Ofgem's decision on modification proposal 0560, '*Publication of Indicative Maintenance Schedule*'.

Cancellation of capacity rights

Transco argues that there is a clear risk of substantial regime change in the medium-term, for example, from Europe (e.g. competition law), domestic legislation (e.g. security of supply) or new regulatory goals (e.g. gas balancing) and that efficient regime change can be hindered by substantial legacy contracts.

Transco states that Ofgem has indicated that it does not believe the cancellation clause is necessary since existing provisions already allow for this outcome in appropriate circumstances, that Ofgem would not wish to have the ability (via Transco's network code) to decide it was appropriate to cancel firm capacity and that it does not believe the proposal is consistent with furthering the relevant objectives. Transco states that given Ofgem's indication, Transco has withdrawn this aspect from the final proposal.

Liabilities under Section I (Entry Requirements) of the Network Code

Transco believes that Section I liabilities as they currently stand are appropriate and should not be amended to be similar to overrun charges, because Section I is intended to incentivise Transco to buy back capacity when necessary or to bear costs in excess of those associated with taking action in a timely manner. Transco states that where there are no buy-back offers available, the price is based on that paid by users for MSEC and the only change proposed is to include QSEC in the latter calculation.

Ofgem's views

Ofgem recognises the significant level of work on the part of both Transco and shippers that has been undertaken in developing this proposal through both the workstream process and through the various consultations that have occurred relating to the development of long-term entry capacity auctions.

Ofgem considers that modification proposal 0500 represents a major step forward in improving the framework under which Transco invests in the NTS. In particular, Ofgem considers that the introduction of long-term entry capacity auctions should significantly improve the signals that Transco receives in determining whether or not to invest in additional capacity. In this respect, the proposal should better facilitate the efficient and economic operation by Transco of its pipeline system by providing a vehicle by which Transco will receive improved signals regarding the demand for entry capacity at particular locations over time. These signals, in combination with the entry capacity investment incentive in Transco's GT licence, should lead to more efficient investment in the NTS reflecting the needs of Transco's customers.

More efficient investment in Transco's system, combined with the certainty provided to the industry from being able to secure long-term rights to access the NTS, will help improve security of supply for customers.

Further, the introduction of long-term auctions will also ensure that shippers can now secure long-term entry capacity rights. In particular, shippers will have the option of securing entry capacity rights up to 15 years ahead, providing increased certainty over entry capacity charges over the long term. This should assist shippers in planning their long-term entry capacity requirements. In this respect, the proposal should better facilitate the securing of effective competition between shippers and suppliers.

Ofgem notes that this proposal has been the subject of a number of amendments following development in the workstream and as a result of supplementary consultations. As such, Ofgem has restricted its comments to only those matters in respect of which Transco has sought to amend its network code.

Allocation mechanisms

Ofgem considers that the release of long-term capacity rights by auction is the most efficient, transparent and non-discriminatory method of allocating long-term entry capacity. Further, long-term entry capacity auctions represent the most reliable method of providing investment signals to Transco as the signals are based on shippers' willingness to pay for entry capacity rights.

Ofgem considers that the range of capacity release mechanisms which make up this proposal allow shippers a significant range of options for securing their entry capacity requirements both over the short and long-term. This will ensure that shippers have the same choice in purchasing entry capacity as they have when choosing whether to contract for gas, where shippers can choose whether to contract long-term, short-term or spot.

Timing of the auctions

As outlined above, in response to concerns raised by industry participants, Ofgem decided to extend the time by which Transco is required to use reasonable endeavours to conduct the first long-term auction. In particular, under the terms of Transco's GT licence it is required to use all reasonable endeavours to conduct the first long-term entry capacity allocation by 1 February 2003. Ofgem notes Transco's proposal to hold the first long-term auction in January 2003 and, against the background of Transco's licence obligations, considers that this would provide shippers with sufficient time in which to fully prepare their auction strategies.

Allocation of the long-term product

Definition of the product

Ofgem recognises the support expressed by the majority of respondents and Transco for a quarterly long-term product. In particular, Ofgem notes that Transco considers that a quarterly product potentially provides it with valuable signals about shippers' seasonal requirements. Ofgem continues to believe that it would be preferable for Transco to release a bundled capacity product potentially over a number of years. However, we recognise the preference of shippers to secure quarterly rights through the primary allocation process and in this respect consider that the definition of the capacity product should be a matter that is largely for capacity market participants to determine.

Duration of sale

Ofgem considers that offering firm tradable entry capacity rights for up to 15 years ahead is a significant improvement over the present system of short-term allocation of capacity rights in terms of the investment signals that it should provide for Transco and the increased certainty it should provide for shippers in planning their capacity requirements.

Bidding process and information release

Ofgem considers that it is important that the auction design does not encourage perverse bidding behaviour or gaming opportunities that may ultimately distort the results of the auctions and the investment signals that they generate. In this respect Ofgem has discussed the details of the design of the bidding process with Transco. We note Transco's view that the proposal minimises gaming opportunities because bidders cannot be certain to what extent competitors will amend their bids.

Notwithstanding Transco's view, Ofgem also recognises that long-term auctions have not previously been undertaken. In this respect, Ofgem will be carefully reviewing and monitoring the activities of bidders in the auctions as part of its normal market surveillance role. Ofgem will also carefully monitor the operation of the auction design, particularly in the first long-term auction to determine whether the design should be modified in any way.

Allocation process

Ofgem notes that the two-month period between the closure of the long-term auction and the notification by Transco to shippers of the results of the auction is the maximum possible time allowed for Transco to assess the auction results and apply its IECR methodology. Ofgem considers that in many situations Transco and Ofgem may be able to shorten this time period.

In this respect, Ofgem considers that it is important that Transco's IECR methodology contains effective decision making criteria for the release of incremental entry capacity. The inclusion of robust criteria should assist in minimising the time period between the completion of the auction and the approval of any incremental capacity proposals under the terms of Transco's GT licence.

Ofgem supports the changes made to the allocation mechanism following the supplementary consultation to largely remove the pro-rating mechanism. This change removes the incentive on shippers to over-bid for capacity at all prices, which may have led to inefficient price escalation and reduced the quality of the investment signals for Transco. Instead under the modification proposal the auction will be cleared at the lowest price at which supply exceeds demand with any residual quantity that is unallocated being made available in future allocations. Ofgem considers that this represents a preferable and more efficient solution to Transco's original proposal by ensuring that the residual quantity of capacity is made the subject of an auction, thereby avoiding an arbitrary allocation.

Allocation of the short-term products

Annual MSEC auctions

Ofgem continues to support the use of pay-as-bid auctions to allocate short-term entry capacity rights, along the lines of the current short-term arrangements. We note the concerns expressed by a small number of respondents about the use of a single round MSEC auction, but accept Transco's argument that, following the completion of the transitional arrangements, the volume of capacity offered should be much smaller than is currently offered and a single round is appropriate in these circumstances.

RMSEC allocation

Ofgem supports the replacement of the off-the-shelf product with a pay-as-bid allocation for unsold MSEC. The RMSEC allocation provides an additional opportunity for shippers to secure entry capacity rights, close to the month of use. Ofgem considers that it is appropriate that the different forms of allocation of MSEC rights are consistent, thereby avoiding any potential inconsistency of treatment between shippers based on the method by which they have secured entry capacity rights. In particular, Ofgem considers that a pay-as-bid allocation for MSEC is more efficient than the prevailing off-the-shelf release mechanism which allocates unsold MSEC on a first come first serve basis against a fixed price. A rolling MSEC auction of this nature should therefore better facilitate the securing of effective competition between shippers and suppliers. Further it also has the advantage of signalling to Transco the value placed on capacity in the short term.

Credit arrangements

In Ofgem's letter of 27 September 2002, which accompanied the modifications to Transco's GT licence, Ofgem indicated that Transco is able to apply to Ofgem for an Income Adjusting Event should it be unable to recover a shortfall in transportation charges or capacity charges as a result of a shipper termination. In this letter, Ofgem indicated that as part of this process it would consider whether the credit arrangements Transco had established were reasonable and commercial in nature, having regard to other credit arrangements adopted for long-term supply contracts in the gas and electricity sectors. Until this has been demonstrated, it would be Transco, and not its customers, that carry the risk of shipper default with respect to entry capacity.

Overrun charges

Ofgem considers that it is important that entry capacity overrun charges should reflect Transco's increased usage of capacity management tools such as forward and options contracts. In this respect, Ofgem supports this element of the proposal. Nevertheless, Ofgem also considers that the method by which overrun charges are derived should ultimately be set out in the System Management Services Adjustment Data methodology ('SMSAD') described in special condition 27 of Transco's GT licence. Ofgem notes in this respect that Transco expects shortly to propose a modification to its network code that may, if implemented, trigger the requirement in Transco's licence to prepare the SMSAD.

Interactions with electricity

This modification proposal implements the allocation of long-term entry capacity rights to Transco's network. Ofgem considers that the implementation of this proposal should, in combination with the investment incentives introduced through the modifications to Transco's GT licence, ensure that Transco invests to meet demand. As such, this should facilitate security of supply on Transco's gas network that is of considerable importance to the efficient operation of the electricity market and the development of efficient signals for investment in generation.

Modification Proposal 0508, 'A Method of Long Term Capacity Allocation'

TotalFinaElf Exploration UK plc ('TFE') raised modification proposal 0508 as an alternative method of allocating long-term entry capacity rights. The arrangements for credit, overrun charges and shorter-term auctions are in line with those proposed in modification proposal 0500 and are not further discussed here. Following release of the proposal, it was further developed in the workstream. The description of the proposal below takes into account these developments.

Allocation mechanisms

In this proposal, long-term entry capacity rights are offered in annual auctions, with any unsold quantities being carried over to the subsequent annual long-term auction. Arrangements for shorter-term auctions are in line with those proposed in modification proposal 0500. However, the proposal provides that the short-term allocations can only commence after the completion of the long-term allocation for that year's capacity.

Allocation of the long-term product

Definition of the product

The long-term product is a quarterly product (QSEC).

Duration of sale

QSEC is sold in an annual allocation relating to the gas year Y+1 through to year Y+25. At the time of the modification proposal, the first allocation would offer for sale capacity relating to periods from 1 October 2002.

Auction process

28 days prior to the long-term auctions, Transco issues a schedule of reserve prices by ASEP associated with the SO baseline output measures, together with an indicative cost schedule for the provision of capacity up to an additional 50 per cent increase in baseline capacities at each ASEP. The reserve prices are determined using the long-run marginal costs for each ASEP in such a way that the reserve prices applied to the SO baseline output measures recover Transco's allowed revenue for entry capacity for that year.

The capacity levels to be made available in the long-term auction for each quarter are also published. These quantities are equal to the SO baseline capacity less previously sold quantities. While TFE raised concerns about the desirability of reserving capacity for release in shorter-term allocations, it allowed for a proportion to be held back if that was required by Transco's GT licence.

Users have one business day in which to submit to Transco the quantities of capacity they demand for each quarter at each ASEP to Transco. If aggregate demand by ASEP in any quarter is less than or equal to the available baseline capacity, then all capacity demanded for that quarter will be offered at the reserve price.

If aggregate demand by ASEP is greater than the available baseline capacity for any quarter, then Transco will recalculate the cost of providing the incremental capacity demanded at each ASEP for the period(s) over which the incremental capacity is required ('the clearing price'). The clearing price will be the weighted average of the reserve price plus the cost of providing the incremental capacity spread over the incremental volumes bid for those periods. In the case of an investment project that provides incremental capacity at more than one ASEP at the same time, then a common unit incremental cost is determined by dividing the total incremental cost by the aggregate of all the related incremental volumes. Transco will publish within a period of [four] This was an initial suggestion of TFE that was never finalised business days the aggregate demand per ASEP per quarter and the clearing price per ASEP per quarter.

Users are then able, within [two] business days, to bid their new quantities demanded for the capacity at these new prices in a second auction round. Following the closure of the second auction round, Transco again recalculates the cost of providing incremental capacity, based on the new bids. This iterative process continues, with four days in between each auction round.

From round three onwards, Transco tracks volumes and prices emerging from the auction process, so that it can apply a closing out technique if this is required at a later stage. The closing out technique is necessary if the allocation process is diverging from a cleared solution. It will be diverging if a clearing

price from a previous bid day lies between the price calculated for the next iteration and that calculated for the current iteration.
Should the process be identified as diverging the following rules apply:

- a shipper cannot bid a higher (lower) volume at a higher (lower) price than the volume it has previously bid; and
- the new price to be used for the subsequent iteration will be the arithmetic mean of the price calculated for the current iteration and the last price calculated by Transco.

The iterative bidding process continues until the clearing prices have changed by less than 2.5 per cent at every terminal and in every period. When this stage is reached, Transco aggregates the users' QSEC demand by ASEP and publishes the aggregate demand at each ASEP for each quarter and the cleared price for each ASEP in each quarter. Users are allocated the capacity they demand in the last iteration and pay the last but one cleared price.

Cost recovery for incremental investment

Incremental investment would be fully funded over the period in which incremental capacity is allocated ('the full cost approach'). Consequently, no incremental investment costs would be added to Transco's Regulated Asset Base ('RAB') and no funding would be provided through subsequent price controls.

If the incremental capacity demanded has been previously built by Transco in anticipation of such demand, the cost included will be the per unit allowance relating to the entry capacity incremental investment incentive cap, as detailed in Transco's GT licence.

Buy-back cost apportionment

Transco's constraint management costs in relation to SO baseline capacity are shared between Transco and users and are subject to Transco's buy-back incentive contained with Transco's GT licence. However, Transco would be liable for 100 per cent of the costs associated with constraints arising from incremental QSEC.

For the purposes of determining Transco's liability, buy-backs on a day are deemed to first relate to any incremental MSEC or DSEC. These buy-backs are accounted for under Transco's buy-back incentive. Additional buy-backs are deemed to relate to any incremental QSEC made available and as noted above, Transco is fully liable for these costs. Where both incremental QSEC and baseline capacity is bought back in a day, the total buy-back costs are allocated pro-rata to the respective quantities of QSEC and all other capacity bought back on that day.

Maintenance information

The proposal provides that the publication of maintenance information is at Transco's discretion.

Respondents' views

TFE stated that it had participated in numerous discussions with Transco in an attempt to amalgamate the positive elements of both proposals and welcomes many of the amendments made by Transco to modification proposal 0500. However, there remain elements in modification proposal 0500 that TFE is unable to support and therefore it continues to support this proposal.

TFE states that only this proposal provides for the following principles:

- the provision of long-term locational volume certainty;
- price certainty, and
- prices reflecting Transco's costs.

Including TFE, there were thirteen responses to this proposal, with two respondents supporting the proposal. One other respondent gave support to the proposal, but considered that it was not yet ready for implementation. Another respondent, while not supporting this proposal, considered that it was a better model than modification proposal 0500.

A number of respondents provided joint responses to modification proposals 0500 and 0508, given the common issues involved in these proposals. The summary below focuses on comments relating to the unique features of modification proposal 0508.

Allocation mechanisms

A number of respondents raised concerns that the proposal fails to provide a transition between the current regime and the long-term regime. In particular, respondents considered that it was necessary to allow for the lead-time for Transco to undertake investment to respond to demand for incremental capacity.

Allocation of the long-term product

Bidding process and information release

Respondents broadly supported the principle of an iterative allocation mechanism, with one specifically noting that it enables bidders to respond to the relative prices emerging from earlier iterations. One respondent suggested that three weeks between the first two iterations and two weeks between subsequent iterations was necessary.

A number of respondents raised concerns about the design of the close out mechanism, with one arguing that discussions had not shown with sufficient clarity that the design would prevent potential gaming. Another suggested that the complexity of the rules, which are needed to ensure that the process closes, might prevent bidders from adjusting to relative price signals. Another respondent expressed concern that the process may last for many weeks.

Allocation mechanism

Two respondents argued that some shippers would be funding additional capacity that they had not demanded, because they interpreted the proposal as requiring that all investment above baseline is funded at all the locations at which additional capacity has been demanded. These respondents also were concerned about the aggregation of costs across periods.

One respondent argued that the closure mechanism added considerable complexity and potentially creates a situation where bidders are unable to adjust their bids.

One respondent supported the requirement on Transco to allocate capacity to the volume that is demanded.

Capacity volumes

In addition to the comments on this issue summarised above in relation to modification proposal 0500, one respondent was uncertain how Transco’s anticipated requirement to reserve 20 per cent of the SO baseline capacity volumes for the short-term auctions interacted with this proposal. TFE, while noting that the requirement would stifle secondary trading and frustrate investment signals, argued that the requirement could be accommodated by the proposal.

Cost recovery

Of the respondents commenting on the appropriate period for investment cost recovery, all expressed opposition to the funding of capacity over the period of signalled demand (rather than over the full life of the asset). Respondents argued that this would result in significant price swings between periods and could result in capacity being allocated at a zero price. One respondent specifically noted that this would not facilitate competition.

Buy-back cost apportionment

A small number of respondents argued in favour of Transco facing the full cost of capacity management, noting that this would give Transco a strong incentive to physically invest, rather than to contract financially to manage the capacity rights allocated.

Transco's views

Transco does not support modification proposal 0508, because it believes that the relevant objectives contained in its GT licence would be furthered to a greater extent if modification proposal 0500 were implemented.

However, Transco does state that the proposal would be expected to better facilitate the efficient and economic operation of the pipeline system by allowing users to contract for levels of entry capacity to satisfy their needs and closely reflect Transco's costs. It also states that Users' seasonal demand will be signalled to Transco, thereby assisting the planning process. Transco states that the proposal would enhance effective competition by offering long-term entry capacity to all users on a non-discriminatory basis and by utilising credit arrangements that maintain low barriers to entry. Transco argues that the proposal would reduce the level of contractual risk to it because all investment is fully funded by users.

Transco argues that, if implemented, this proposal may require its anticipated entry capacity investment incentive to be reconsidered. In particular, Transco states that the proposal is based on an obligation to provide additional entry capacity rather than reflecting risks and rewards specified in an incentive. It argues that an obligation to provide capacity may change the relationship between Transco and each user, in particular where curtailment of firm capacity is required.

Allocation mechanisms

Transco states that systems development is required to implement this proposal and it anticipates that these could not be delivered to facilitate the first allocation process before February 2003.

Allocation of the long-term product

Duration of sale

Transco states that the necessary lead-time to build new capacity is around three years and for periods less than three years, its ability to provide additional capacity is limited to marginal gains through reconfiguration of existing plant. Transco argues that, in such circumstances, an allocation process that rationed demand to existing capacity might be expected. It argues, however, that this proposal obliges it to satisfy demand for additional capacity regardless of its ability to deliver. Transco argues that this may increase constraint costs, which are shared between Transco and users.

Bidding process and information release

Transco shares a respondent's concern with the length of time the auction could take to close out, especially in light of the proposal applying from October 2002. It also shares a respondent's concerns about possible gaming opportunities of the close-out procedure and believes that modification proposal 0500 would provide a better allocation mechanism.

Allocation mechanism

Transco interprets the proposal as implying that Users may fund additional capacity that they might not have requested via the bidding process, and argues that this may not be appropriate or efficient. Transco argues that this situation could arise from either locational and/or temporal issues. It says that the proposal defines that all investment to support capacity provision above baseline is funded by users at all the locations at which additional capacity has been demanded. For example, if demand is signalled at both Bacton and St Fergus, Users at both ASEPs would be required to share the bundled costs. Similarly, Transco argues that the proposal would imply that a user requesting capacity in a particular year might be required to share the costs of providing capacity in another year.

Capacity volumes

Transco believes that the proposal is not consistent with the proposed amendments made to its GT licence relating to the requirement to reserve a proportion of long-term capacity for short-term auctions. It states that this might be considered to increase barriers to entry for new entrants.

Buy-back cost apportionment

Transco believes that the proposal is not consistent with the proposed amendments made to its GT licence relating to its SO buy-back incentive.

Ofgem's views

Ofgem recognises the significant contribution made by TFE to the development of long-term entry capacity allocations through its work on this proposal and, indeed, through its participation in the development of modification proposal 0500. Ofgem considers that this has been valuable in encouraging debate and discussion within the industry on the most appropriate form for the long-term entry capacity auctions.

Ofgem notes the concerns that TFE has raised in a letter to the industry of 20 August 2002 regarding the accuracy of Transco's description of the modification proposal as outlined in Transco's final modification report. Ofgem has therefore assessed this proposal on the basis of that described by TFE and as outlined in the business rules for the proposal.

As has been noted above, Ofgem has considered this proposal together with modification proposal 0500. As a matter of practicality, it is not possible to direct implementation of both modification proposals 0500 and 0508. As such, Ofgem has decided to implement modification proposal 0500 as Ofgem considers that Transco's proposal better facilitates the achievement of the objectives outlined in amended Standard Condition 9 of Transco's GT licence. Against this background, Ofgem offers the following comments on modification proposal 0508.

The proposed long term entry capacity allocation mechanism

In many respects Ofgem considers that elements of this modification proposal 0508 would facilitate competition between shippers and the efficient operation of Transco's pipeline system. In particular, the ability of shippers to secure long-term entry capacity by means of a non-discriminatory auction process would facilitate the securing of effective competition between shippers. Further, the signals provided by a long-term auction of the nature proposed in modification proposal 0508 could significantly improve the information available to Transco on which to make investment decisions.

However, modification proposal 0508 differs from modification proposal 0500 in a number of important respects. In particular, the proposal provides for the release of incremental capacity only in circumstances where the full cost of this capacity has been funded through bids received in the auction. Secondly, the proposal exposes Transco to 100 per cent of the costs of buying back incremental entry capacity. Ofgem has concerns with these elements of the proposal and for the reasons outlined below does not believe it should be implemented.

'Full cost' approach to investment

Ofgem considers that the adoption of a 'full cost' approach to the release of incremental entry capacity may not always produce efficient investment outcomes. In particular, Ofgem is concerned that the approach proposed could lead to inefficient under-investment, as it is reliant on the full costs of investment being met through incremental revenues from twenty-five year auctions. In this respect, Ofgem considers there is a risk under the approach outlined in modification proposal 0508 that otherwise efficient investments may not occur (or at the very least be delayed).

Buy back cost apportionment
TFE has proposed that Transco should be exposed to 100 per cent of the costs of buying back incremental entry capacity.

Transco currently has a buy-back incentive contained within its GT licence that has been the subject of separate consultation. The incentive exposes Transco to a share of capacity management costs with caps and collars on Transco's potential gains and losses. The incentive was set for a period of two years due to future uncertainties associated with buy-back costs. In setting this incentive Ofgem did not consider that it was appropriate to expose Transco to 100 per cent of the costs of buy-backs due to these uncertainties. On this basis, Ofgem does not believe that it is appropriate to expose Transco to 100 per cent of the costs of buy-backs through modification proposal 0508.

Ofgem intends to review this incentive for the period commencing 1 April 2004 and will at this point consider the level of exposure that Transco should face with respect to both baseline and incremental entry capacity that has been released and the period over which it should face this exposure.

Maintenance
Ofgem notes TFE's proposal that the timing of the release of Transco's maintenance programme be left to Transco's discretion. In particular, the proposal indicates that maintenance plans will not be published for a period of up to 12 months in advance until after the completion of the 'primary allocation and forward contracting'.

Ofgem does not believe that it is appropriate that Transco have discretion not to publish its maintenance programme on the basis suggested by TFE. Instead, as outlined in our decision on modification proposal 0560, *'Publication of indicative maintenance schedule'* Ofgem considers that it is important that maintenance information for a particular year be published on an indicative basis ahead of the annual entry capacity auctions for that year. In particular, Ofgem considers that this information would assist shippers in efficiently valuing capacity in the auctions. The information that Transco receives from the auctions would in turn assist Transco in determining whether to adjust its maintenance programme to minimise the costs associated with capacity buy-backs.

Ofgem's Decision

For the reasons outlined above, Ofgem has decided to direct Transco to implement modification proposal 0500 because we consider that it better facilitates the achievement of the relevant objectives as outlined under amended standard condition 9 of Transco's GT Licence. Further, Ofgem considers that modification proposal 0500 best facilitates the achievement of the relevant objectives as compared with modification proposal 0508.

This document, and its letter attachment, constitutes relevant notice of the reasons for the Authority's decision in respect of modification proposal 0500 and 0508 as required by the Gas Act 1986.