

Transco, Shippers and Other interested parties

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Dear Colleague,

Modification Proposal 509: Tender for Enron's MSEC holdings

Ofgem has carefully considered the issues raised in Modification Proposal 0509 '*Tender for Enron's MSEC holdings*'. Ofgem has decided to direct Transco to implement this modification because we believe that it better facilitates the relevant objectives of Transco's Network Code.

In this letter we outline our reasons for this decision.

Background to the proposal

Transco's capacity release

In September 1999, Transco conducted the first auctions for the sale of Monthly System Entry Capacity (MSEC) to the National Transmission System (NTS). The monthly auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000). Further MSEC auctions were held in March 2000, August 2000, February 2001 and September 2001.

In addition to holding monthly auctions, Transco makes firm and interruptible capacity available on a daily basis where there is additional capacity physically available. A within-day capacity market became operational on 1 June 2000.

Following the September 1999 entry capacity auction a number of modifications to the auction regime were proposed to address issues that were unresolved prior to the introduction of the auctions in October 1999. One of the main areas of concern was that the existing allocation methodology resulted in too little capacity being released in the monthly auctions relative to the physical capabilities of the NTS. Under the entry capacity regime, MSEC quantities were determined through the application of the Seasonal Normal Demand (SND) methodology. This methodology used historic terminal gas flow data to determine the amount of capacity to be made available at each terminal and did not take account of gas market developments such as new fields, or changes to existing fields' profiles and to gas sales contracts.

Ofgem recognised prior to the introduction of the auctions that the SND methodology was flawed and should only be adopted as an interim measure for the determination of MSEC volumes. This position was clearly stated in our September 1999 decision document¹. Since October 1999, a number of modifications to the Network Code have been proposed to address this issue. Most recently, Conoco UK Ltd raised modification 0481 '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*', which provided for a significant increase in the volumes of capacity released in the September 2001 MSEC auction. Specifically, this modification proposed that the release of MSEC quantities for each Aggregate System Entry Point (ASEP) for each month be equivalent to the highest of the monthly ASEP Maximum System Entry Capacities.

In accepting this modification on 9 August 2001, Ofgem indicated its preference for a monthly capacity release that is linked to the maximum physical capacity available at each terminal. In particular, Ofgem considered that a maximum physical capacity approach is the only robust and verifiable measure of actual capacity at each entry point. Ofgem also indicated that a maximum physical approach is a simple and transparent method of releasing capacity and reduces any Transco discretion in determining how much capacity to release. Ofgem also considered that such an approach removes the existing reliance on historical data and the possibility that a historically based methodology, such as an SND approach, could artificially restrict

¹ '*The New Gas Trading Arrangements: A decision document*', Ofgem, September 1999

the amount of capacity being released or create a perception that capacity is being artificially restricted. It removes the possibility that scarce capacity is allocated to terminals not on the basis of price but on the basis of an artificial allocation mechanism.

Transco's capacity incentive

In order to encourage Transco to make all capacity available to market and manage constraints in an efficient manner, an incentive regime was put in place on 1 October 1999. Under this regime, Transco retained 20% of any additional revenue associated with the sale of daily firm and interruptible capacity. Conversely, Transco was liable for 20% of the costs of buying back capacity in the event of a constraint. Transco's gains and losses under the scheme are capped at £5m and divided into equal monthly caps.

The incentive arrangements were set on the basis of the risks/rewards associated with using the SND methodology to determine the proportion of available capacity to be released in the monthly auctions. As the SND methodology attempted to determine likely capacity availability under seasonal normal temperatures, the incentive was constructed around a zero mean, with the likely value of daily capacity sales being offset by the likely value of buying back capacity in the event of a constraint.

Following the acceptance of modification 0481 '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*', Transco raised modification 0488, '*Redesign of Capacity Incentive Regime*'. This modification removed the existing entry capacity incentive whereby Transco was liable for 20% of the costs of buying back capacity in the event of a constraint, subject to caps and collars.

The modification implemented a new incentive under which Transco's Capacity Incentive Performance Measure (CIPM) would be based on the magnitude of the net cost (revenue) of actual costs of capacity buy-backs and incremental sales revenue for a month compared to a target level of costs agreed in advance. Where CIPM is equal to zero (i.e. actual costs are equal to forecast) Transco will face no reward or penalty. Under the incentive Transco obtains rewards (penalties) when actual costs are lower (higher) than the forecast. The modification retained the existing maximum potential risk and reward of +/- £416 000 per month. Ofgem accepted the modification on 24 August 2001. In accepting the proposal Ofgem agreed that an approach that was based around the target level of buy-back costs was

appropriate given the overall changes to the regime and the release of more capacity in the monthly auctions.

Termination of Enron affiliated shippers as Network Code Users

With effect from 6am on 1 December 2001, Enron Gas and Petrochemicals Trading Limited and Enron Capital and Trade Resources Limited ('Enron') were terminated as Network Code Users, in accordance with Section V4.3.1 of the Network Code.

Under the provisions of the Network Code a terminated User cannot hold (or resell) entry capacity. As a result Transco has recalled the prospective MSEC previously held by these shippers (except where the capacity has been transferred to another party and provided that party pays Transco for the capacity). Consequently, the quantity of capacity held by users has been reduced below the quantities originally sold in the September 2001 MSEC auctions. In response to this reduction in MSEC holdings Transco has been releasing additional volumes of firm entry capacity rights on a daily basis. The revenues from these sales are redistributed to shippers via neutrality. Within-day sales of capacity are included in the calculation of Transco's Capacity Incentive Performance Measure (CIPM), and net against any buy-back costs incurred.

The modification proposal

The modification proposal seeks to offer the recalled MSEC for the period January 2002 to March 2002 via an auction process. It is proposed that the auction should occur on a similar basis to that defined under Section B2.3 of the Network Code. Under the proposal Transco would issue an invitation to tender which would ask shippers to bid for the recalled MSEC. The tender process would open on 19 December at 9:00 and the last time by which bids would be accepted is 17:00 on the same day. Under the proposal any secured MSEC holdings will have the same rights and obligations as if it had been secured during the original MSEC auction process.

Respondents' views

The majority of respondents either supported the proposal, the principles underlying the proposal or offered conditional support for the proposal.

A number of respondents who offered support for the proposals did so on the basis that the release of recalled capacity through an MSEC auction process maintained the principle of Modification proposal 0481.

One respondent noted that to withhold any amount of capacity would be a distortion of the original allocation to all users collectively. This respondent went on to suggest that the capacity should be sold in the form of an allocation that most closely replicates the original allocation and that the capacity should be sold over two rounds. Another respondent, noted that auctioning the capacity is the most equitable way of making the recalled capacity available to the industry. This respondent also stated that this would ensure that revenues would be treated as formula revenue as in the original MSEC process. However, the respondent went on to argue that there was insufficient time for the implementation of this modification, suggesting that the tender process should be delayed until January 2002 for February and March 2002 capacity with January 2002 capacity sold in the daily auction.

A number of respondents supporting the principles of the modification indicated that the release of the recalled capacity via an MSEC process would provide potential purchasers with greater certainty about procuring their requirements ahead of time rather than relying on shorter term markets.

One respondent commented that releasing the capacity on a daily basis will add revenues to Transco's incentive which would represent a distortion of anticipated financial flows.

One respondent recognised that the implementation of the modification may increase systems risks to Transco. However the respondent indicated that nothing should occur that gives the impression of shippers carrying the risks that might be associated with Transco's management and IT systems.

The majority of those respondents opposing the proposal support the current method of releasing the recalled capacity adopted by Transco, whereby the capacity is released at the day-ahead stage. Several of these respondents also commented upon the costs associated with introducing the proposal. One respondent commented that the merits of the proposal are outweighed by the complications and time required for its implementation. Another commented that the development of the entry capacity regime beyond 1 April 2002 should take greater priority over the proposal. The respondent commented that the tender would take up industry participants' time and resources. It indicated that these resources are better placed in developing the forthcoming longer-term entry capacity regime.

This respondent also indicated that it was inappropriate to introduce a process for addressing the sale of recalled capacity from a terminated user via an urgent modification proposal that has been raised under a shortened consultation period. The respondent stated that the proposal has wider implications and that further thought needs to be given to introducing future, more robust arrangements that might need to be invoked in the event of a shipper default.

One shipper recognised that a daily release of capacity would run counter to the objectives of mod 481 but argued that it would be imprudent to force Transco to release capacity simply to force buy-backs.

One respondent argued that introducing an auction for the re-allocation of the recalled capacity would be expensive and may set a precedent that may be inappropriate where a terminated company only has a small volume of capacity.

Transco's views

Transco does not support the implementation of this modification proposal.

Transco has stated that it supports the view that the principles of modification 481 should be upheld, but that in their view there are unacceptable risks associated with the proposal. In particular, Transco considers that following any tender for the recalled capacity, it would be necessary to data-fix essential information into the RGTA IT system which contains all of the data relating to all entry capacity held by Users. Transco considers that any data fixing activity that takes place will increase the risk of errors potentially impacting upon the maintenance of data integrity. Transco believe this could expose shippers to inaccurate information regarding their entry capacity holdings.

Transco also believes that the Network Code currently provides for the release of capacity recalled by Users without the need for a Network Code change.

Ofgem's views

As a general principle Ofgem considers that the treatment of any recalled capacity from a terminated user should not undermine the intent of modification 0481 which provided for the release of monthly capacity linked to the maximum physical capacity available at each terminal.

In Ofgem's view the termination of the two Enron shippers as Network Code Users has effectively and materially, reduced the available capacity below the levels specified by modification 0481. Ofgem accepts that Transco has been releasing this capacity on a daily basis and that this additional release was an appropriate interim response following the termination of Enron. However, Ofgem believes that the release of the recalled capacity on a daily basis would undermine the principles associated with the maximum physical capacity approach to monthly releases established through modification 0481.

Ofgem is also concerned that the continued daily release of this capacity differs materially from a release of MSEC in advance of the day to which the capacity relates. In this respect Ofgem agrees with respondents that the ability of shippers to book the recalled capacity on a monthly basis provides potential purchasers with greater certainty about procuring their requirements ahead of time rather than relying to a large extent on daily markets. In particular under a daily release, shippers will have less certainty as to whether they will manage to secure their capacity requirements. A release of the recalled capacity under the tender proposed will assist in allowing unsuccessful shippers to plan whether or not to adjust future flows of gas onto the NTS or to secure capacity on the secondary market. Ofgem considers that this will better facilitate the securing of effective competition between shippers.

Further, Ofgem believes that the release by Transco of the recalled capacity on a daily basis is also inconsistent with the profile of risks and rewards that Transco faces under its capacity incentive established through modification 0488. In particular, any within-day sales of firm capacity are incorporated into the CIPM and net against any buy-back costs when Transco's incentive revenue is calculated. In this respect, consistent with views previously expressed on a number of past modification proposals, Ofgem considers that the profile of risks and rewards should not be materially altered within an incentive period.

Ofgem recognises the concerns raised by one respondent that the implementation of this modification could result in Transco conducting costly future auctions for relatively small proportions of capacity held by a terminated User. However, Ofgem considers that should this occur in the future, a modification proposal could be raised to address the concern raised by the individual case in question.

Ofgem's decision

Ofgem has decided to direct Transco to implement this modification because we believe that it better facilitates the relevant objectives outlined under Standard Condition 9 of the Gas Transporter's licence. In our view, releasing the recalled capacity which relates to January, February and March 2002 via an auction process well ahead of the period of use, will better facilitate the objective of securing effective competition between relevant shippers by providing shippers with increased certainty in managing their capacity requirements.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the telephone number above.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements