Shippers, Transco and other interested parties

Our Ref: net/cod/mod/0695
Direct Dial: 020 7901 7437
Email: Andrew.walker@ofgem.gov.uk

13 August 2004

Dear Colleague,

Network Code Modification Proposal 0695 – *Entry Capacity Allocation where Demand Equals Supply*

Transco raised modification proposal 0695 *Entry Capacity Allocation where Demand Equals Supply* on 14 May 2004.

Ofgem has carefully considered the issues raised in this proposal and has decided to direct Transco to implement the modification as it better facilitates the achievement of the relevant objectives of Transco's network code, as set under standard condition 9 of Transco's Gas Transporter (GT) licence.

In making this decision Ofgem has taken into account its statutory duties and Transco's obligations under its GT licence. The reasons for this decision are set out below.

Background to the proposal

Following Ofgem's approval of modification 0500 Long-Term Capacity Allocation in September 2002 Transco auctions quarterly system entry capacity (QSEC) rights to enable shippers to access the national transmission system (NTS) up to 15 years ahead. The next long-term auction is scheduled for September 2004 offering capacity from April 2006 until March 2021.

Shippers are invited to bid in the QSEC auctions against a set of prices for the quantity of entry capacity they are seeking to acquire at each terminal in each available period for up to 15 years in advance. Transco applies reserve prices, which apply to the baseline quantities and a series of step prices reflecting the costs of expanding capacity. The step prices and reserve prices for each terminal are published in Transco's Transportation Charges statement. Transco's pricing methodology has produced upwardly sloping price schedules for existing terminals. Both the step prices and the methodology used to calculate them are set out in Transco's incremental entry capacity release (IECR) methodology statement. Transco consults on and Ofgem approves the form of the IECR methodology statement on an annual basis, as set out under special condition 28B of Transco's GT licence.

New entry terminals

Following the approval of modification proposal 667 *Allocation of incremental system entry capacity at system entry points with descending price schedule* in December 2003, the network code was amended to avoid a potentially inefficient allocation of capacity at new entry terminals. The modification reflected Transco's calculation of price schedules at three new entry terminals, where there are downward sloping price curves.

Relevant step price group

Under the current network code provisions, when considering bids submitted for incremental quantities of capacity at a terminal with an upward sloping price schedule, as specified in the annual auction invitation letter, Transco allocates a step price group against bids based upon the first price step where demand is equal to or less than supply.

When considering bids for incremental quantities of capacity at a terminal with a downward sloping price schedule, as specified in the annual auction invitation letter, Transco allocates a step price group against bids based upon the last step price where demand is equal to or less than supply.

The proposal

Transco's modification proposal 0695 would allow for the allocation of system entry capacity at the price step where demand precisely equals supply ie where based upon a bidder's actual price signal.

Respondents' views

Transco received one response to this modification proposal. The respondent offered support for its implementation.

The respondent stated that there was inconsistency between the methodologies to allocate entry capacity under the IECR methodology statement and the network code. The respondent considered that the network code, as currently worded, would not provide the most efficient price in cases where demand was inelastic in an auction allocation. It stated that by changing the network code so that capacity was allocated at the price step where demand equals supply, regardless of whether demand was constant or responsive to price, both methods would be consistent. The respondent considered that this proposal would also ensure that capacity would be allocated at the price step where demand equals supply and at which a bidder had signalled its demand, particularly at terminals where there was only one bidder.

Transco's views

Transco supported the implementation of this proposal. It noted that its draft IECR methodology statement (the final version of which is due to be published in August 2004) proposed that the applicable quantity of capacity for release should be considered at the highest price step where demand exceeds or is equal to supply.

Transco considered that this modification proposal would align the network code provisions with the draft IECR methodology statement and would ensure that capacity would be allocated precisely at the price step where demand equals supply. Transco stated that this approach would allow capacity to be allocated efficiently.

Ofgem's views

The application of current network code rules could lead to an inefficient allocation of capacity in those instances where demand precisely equals supply on an upward or downward sloping price schedule.

The proposal should better facilitate Transco's efficient and economic operation of its pipe-line system by introducing a mechanism to enhance the ability of shippers to bid effectively for system entry capacity at entry terminals where Transco has produced an upward or downward sloping price schedule. Effective bidding and step price allocation in a long-term auction should enhance Transco's network investment and planning information by allowing shippers to signal their demand for entry capacity at each terminal and by allowing Transco to release capacity at a cost reflective price.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to direct Transco to implement modification proposal 0695 because it better facilitates the achievement of the relevant objectives of Transco's network code as set out under standard condition 9 of Transco's GT licence. In particular, the proposal better facilitates the achievement of the efficient discharge of Transco's obligations under its GT licence.

If you have any further questions regarding this letter please do not hesitate to contact me on the above number or Tolani Azeez on 020 7901 7043.

Yours sincerely

A J Walker

Andrew Walker
Director – Transmission networks regulation