



Shippers, Transco and Other Interested
Parties

*Bringing choice and
value to customers*

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04 August 2003

Dear Colleague,

Modification Proposal 0621 *'Determination of Additional Available Daily System Entry Capacity'*

Transco raised modification proposal 0621, *Determination of Additional Available Daily System Entry Capacity*, on 10 April 2003.

Ofgem has considered the issues raised in this modification proposal and the responses received and has decided to direct Transco to implement this proposal because we believe that it will better facilitate the relevant objectives of Transco's network code.

We have set out below our reasons for making this decision.

Background

Transco allocates entry capacity rights to its National Transmission System (NTS) through a series of long and short term auctions. Under the entry capacity regime

established in Transco's Gas Transporter (GT) licence, Transco is funded to provide a series of baseline output measures of entry capacity for each system entry point. These baseline output measures are based on the maximum physical capability at each system entry point and are referred to as Transco's transmission asset owner (TO) baseline output measures. Transco is obliged to offer 90 per cent of these output measures (system operator (SO) output measures) for sale as entry capacity rights.

Transco has an SO entry capacity investment incentive, under which it has the potential to earn higher rates of return on the sale of obligated incremental entry capacity rights. These rights are additional to the SO baseline output measures, and can be released where there is demand for such capacity signalled in auctions and following an application by Transco, under its GT licence, to Ofgem demonstrating that it has met the criteria for the release of this capacity as set out in its Incremental Entry Capacity Release statement.

Transco may also sell incremental entry capacity rights as non-obligated incremental entry capacity. For example, Transco may choose to sell these rights close to the gas flow day in anticipation that it can accommodate increased flows onto its system, without necessarily needing to invest to expand the capability of its system.

To the extent that Transco is unable to accommodate expected flows against firm entry capacity rights at a system entry point, Transco must buy back these rights at market determined prices. It has an SO incentive to minimise the net cost of buy-back actions (the buy-back incentive), under which it has a target range of between £10 and 20 million of buy-back costs less the revenue derived from sales of non-obligated incremental entry capacity and all sales of obligated entry capacity released within day. To the extent that its performance exceeds the target range, Transco shares the gains equally with shippers, whereas it is exposed to 35 per cent of performance below the target range. Transco's incentive exposure is limited to £30 million on the upside and £12.5 million on the downside. Transco's entry capacity buy-back incentive is due to be reviewed for April 2004.

The first long-term entry capacity auctions, in which Transco offered quarterly system entry capacity 15 years ahead, were held in January 2003 and the next long-term auctions are due to be held in September 2003. Transco continues to offer monthly system entry capacity (MSEC) rights in annual auctions to be held in

February of each year from 2004, following a transitional six-monthly MSEC auction to be held in August 2003.

Transco also releases daily system entry capacity (DSEC) on a day-ahead and within-day basis. Transco's network code provides that Transco will make available as day-ahead capacity any unsold obligated entry capacity, as well as any additional capacity that Transco in its sole discretion chooses to make available.

Transco's network code also provides for the release of daily interruptible entry capacity, based on the extent to which holdings of daily firm entry capacity exceed the quantity of deliveries of gas at each system entry point. This is referred to as 'use-it-or-lose-it' (UIOLI) capacity and is intended to operate as an anti-hoarding device, to prevent capacity being hoarded and not flowed against. The release of UIOLI capacity does not affect the rights of firm entry capacity holders and Transco is able to scale back interruptible capacity for no cost in order to alleviate an entry capacity constraint. The revenue from UIOLI capacity also nets off against Transco's buy-back costs under its buy-back incentive.

The proposal

Modification proposal 0621 provides that the determination of Available Within-Day Capacity should be amended to equal the sum of any Unsold System Entry Capacity plus any additional DSEC that Transco may in its sole discretion choose to make available for the day.

Transco recommended implementation of the proposal from 1 October 2003.

Respondents' views

There were nine responses to this modification proposal. All respondents expressed support for the proposal, with a number qualifying their support.

In general, respondents considered that the proposal would allow Transco to release additional capacity if it was able to accommodate the associated flows of gas and remove any unnecessary constraints on gas being able to be flowed onto Transco's system. Respondents commented that the proposal would improve the efficient operation of Transco's system. A number of respondents also considered that the method by which Transco decides the quantity of capacity to release within day should be consistent with that used for day-ahead release.

The majority of respondents recognised the risk that there was the potential for increased buy-back costs arising from the proposal. However, several respondents considered that Transco would take this into account in determining whether to release additional within-day capacity, at least while Transco's incentive was active.

The concerns expressed by those respondents offering qualified support for the proposal were as follows.

One respondent had concerns with how Transco would manage any extra capacity made available and questioned whether it may result in more interruption of the interruptible capacity product.

One respondent supported the proposal only if any additional revenue could offset extra exposure to buy-back costs. Another respondent was concerned that Transco may limit the release of within-day capacity if it has discretion, compared with following a mechanistic network code approach.

Transco's views

Transco supported the proposal and stated that it believed it should reduce the risk of stranding gas off-shore within day, by enabling it to take into account a range of factors, including the probability that previously released capacity will be flowed against. It considered that the proposal would increase the efficiency of capacity release, which might be expected to increase the ability of shippers to be able to purchase capacity, thereby promoting competition between shippers. Transco stated that the proposal may prevent higher secondary capacity prices.

Transco also stated that the proposal would enable it to apply a consistent process to determine the release of both day-ahead and within-day capacity.

Transco stated that it anticipated that the proposal may impact on its buy-back incentive, to the extent that it would be able to release more DSEC within day and to the extent that there will be a potential for increased buy-back costs. However, it considered that in exercising its discretion to release additional capacity within day (under this proposal), it would manage the impact of any buy-back exposure by taking into account the prevailing system capability and gas flow expectations in order to strike an appropriate risk/reward balance. Transco stated that its interests

were aligned with those of shippers through the incentive arrangements and the proposal would generate a shared benefit between Transco and shippers.

In response to the concern expressed by one respondent that the proposal may result in a higher incidence of interruption of interruptible capacity, Transco recognised that this could occur. Transco considered that shippers would need to take this into account in determining which type of entry capacity product to secure.

Ofgem's views

Ofgem considers that this proposal will allow Transco to respond to its incentives more efficiently by enabling it to maximise the availability of firm entry capacity within day. As such, the proposal should prevent entry capacity being artificially withheld from the market and should, therefore, better facilitate competition between shippers and suppliers seeking to bring gas onto Transco's NTS.

Ofgem notes the views expressed by one respondent and Transco that this change may impact on the extent to which UIOLI capacity is interrupted and therefore affect the value of UIOLI capacity. Ofgem accepts that this may be the case and agrees with Transco that shippers will need to factor this risk into account when securing firm and interruptible capacity rights.

Further, whilst UIOLI capacity is intended to guard against hoarding of capacity, Transco should also be able to release additional firm entry capacity for sale to the extent that it considers that existing firm rights will not be flowed against.

Ofgem notes the concerns expressed by some respondents about the potential for increased buy-back costs should Transco release additional daily firm entry capacity within day. However, Ofgem considers that Transco has been provided financial incentives under its GT licence to efficiently trade off the risks and rewards associated with the extra release of capacity and should therefore take into account the risks of buy-backs in reaching any such capacity release decisions.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to direct Transco to implement this modification proposal, because we consider that it would better facilitate the relevant objectives of the efficient and economic operation of Transco's system and the securing of effective competition between relevant shippers and between

relevant suppliers, as contained in amended Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on telephone number 0207 901 7431.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'M Feather', written in a cursive style.

Mark Feather
Head of Gas Trading Arrangements