



Shippers, Transco and Other Interested
Parties

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value to customers*

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Dear Colleague,

Modification Proposal 0625' Short term six month auctions'

Shell Gas Direct raised modification proposal 0625 '*Short term six month auctions*' on 8 April 2003.

Ofgem has carefully considered the issues raised in this modification proposal and has directed Transco not to implement this modification proposal because we do not consider that it better facilitates the relevant objectives of Transco's network code, as set out under standard condition 9 of Transco's Gas Transporter (GT) licence.

In making our decision Ofgem has taken into account Transco's obligations under its GT licence, our wider statutory duties and all relevant facts.

Ofgem has also issued today its decisions accepting modification proposals 0616 '*Revision to the Standard Year for purposes of acquiring and holding Annual Monthly System Entry Capacity*' and 0617 '*Revision to the Standard Year for purposes of acquiring and holding Long-term System Entry Capacity*'. These decisions have been published in separate letters.

We have set out below the reasons for making our decision on modification proposal 0625.

Background to the proposal

System Entry Capacity Auctions

Transco has allocated monthly system entry capacity (MSEC) rights to access the national transmission system (NTS) via six monthly entry capacity auctions since September 1999. The most recent MSEC auctions were held in February 2003 and covered a period from 1 April 2003 to 30 September 2003. The first annual monthly system entry capacity (AMSEC) auction, which is designed to allocate capacity for 12 months, is scheduled for July 2003 for the period October 2003 to September 2004.

Transco also releases firm and interruptible capacity on a daily basis where there is additional capacity available. In addition, in the event that expected flows exceed both the capability of the system at an entry point and the amount of capacity held by shippers at that terminal, Transco is able to scale back interruptible capacity and to the extent necessary buy back firm entry rights at market determined prices.

Timing of Monthly System Entry Capacity Auctions

The provisions of the network code originally envisaged that the MSEC auctions held in August 2000 would allocate entry capacity for a twelve month period from 1 October 2000 to 30 September 2001. However, the capacity period was subsequently shortened to six months following Ofgem's acceptance of modification proposal 0409 *'Review of monthly auction capacity parameters'*.

In respect of the February 2001 auction, Transco proposed a move to a 12 month capacity release period through modification proposal 0444 *'Extend capacity period sold to 12 months in MSEC and MISEC auctions for February 2001'*. Ofgem rejected the modification proposal at that time as we recognised a number of concerns expressed by respondents regarding uncertainties created by the short period of time available before the commencement of the auctions.

On 19 July 2002, Ofgem directed Transco to implement modification proposal 0564, *'Amendment to period of summer capacity auctions to six months'* which provided for two separate six-month allocations of entry capacity for the gas year 2002/2003.

In its decision letter, Ofgem stated that it continued to prefer a move to longer-term auctions of entry capacity in order to provide price signals to Transco for investment in the NTS and to allow shippers to secure longer-term entry capacity rights.

Ofgem recognised that the introduction of a 12 month auction at that point in time would be inappropriate because of the concerns expressed by respondents regarding the uncertainties in the capacity regime and the impact of these uncertainties on shippers preparing bidding strategies for the auctions. Ofgem therefore considered at that time that a six month auction of entry capacity for summer 2003 would better facilitate the securing of effective competition between relevant shippers and relevant suppliers.

Long-term entry capacity auctions

Following Ofgem's approval of modification 0500, '*Long-Term Capacity Allocation*', Transco now makes available quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use. These rights are issued via annual long-term entry capacity (LTSEC) auctions. The first long-term auction was held in January 2003 for the purposes of allowing shippers time to prepare to bid in the auctions, following the final implementation of modification 0500 in September 2002.

Following the implementation of modification 0500, Transco has an obligation to issue annual invitations for MSEC and QSEC auctions not earlier than 1 August and not later than 31 August in each gas year.

Transco's transportation charges

Transco levies transportation charges on shippers to recover its NTS allowed revenue as determined under its price control. In particular, Transco collects its NTS TO allowed revenue through entry and exit capacity charges and its NTS SO allowed revenue through an SO commodity charge. Modifications made to Transco's GT licence on 27 September 2002 established Transco's Transmission Asset Owner (TO) price control from 2002–2007 and put in place a series of System Operator (SO) incentives for the NTS. Transco is required to use its best endeavours in setting its charges to ensure that, in respect of any formula year, the revenue from such charges does not exceed its price controlled maximum allowed revenue for each of its TO and SO controls.

Transco may need to adjust the level of its transportation charges periodically in order to ensure that it meets its price control obligations. Changes of this nature may be required in the event that Transco has incorrectly forecast its expected

revenues for a formula year. In addition, where revenues received from entry capacity auctions suggest that Transco may exceed its allowed revenue for a particular year, charges may be adjusted to ensure Transco does not over recover against this allowed revenue.

Under the provisions of its GT licence, Transco must use reasonable endeavours to give the Authority notice of a proposal to change its charges at least 150 days before the proposed date of implementation.

Further, under the current network code arrangements, Transco is required to provide no less than two months notice prior to the implementation of any revised transportation charges.

Ofgem has previously indicated that Transco should give consideration to revising its transportation charges once a year only, with sufficient notice being given to shippers of this change.¹ In particular, Ofgem has stated that restricting changes to transportation charges on an annual basis would facilitate competition in the wholesale gas market. Transco's recent pricing discussion paper (PD17) *Setting of NTS Transportation Charges* sought views on a number of alternatives to the present arrangements for the setting of gas charges, including a proposal for charges to be set normally once a year even if there was an over or under recovery within year.

Related modification proposals

Separate to this proposal, British Gas Trading has also raised modification proposal 0616, *'Revision to the Standard Year for purposes of acquiring and holding Annual Monthly System Entry Capacity'* and 0617, *'Revision to the Standard Year for purposes of acquiring and holding Long-Term System Entry Capacity'*.

Modification proposal 0616 provides for a revision to the timing of the AMSEC auction process in order to align the sale of entry capacity with Transco's formula year and baseline capacity periods. Under the proposal AMSEC auctions would occur in February of each year, from 2004, for capacity for the following April (Y) to March (Y+1).

¹ See for example, Ofgem's decision letter with respect to Transco's Pricing Consultation paper PC 75, *'NTS TO Commodity charge'* and Ofgem's decision letter approving network code modification proposal 0576, *'Provision of information relating to the SO commodity charge'*.

Modification proposal 0617 provides for the LTSEC auctions to be held in September of each year, offering capacity for the period April (Y+2) to March (Y+16).

The proposal

Modification proposal 0625 provides that AMSEC auctions be held every six months, namely, in February for April to September capacity, and in August for October to March entry capacity. Under the proposal, entry capacity for the following year would continue to be released in annual strips. The modification proposal also states that the LTSEC auctions would be held in September of each year. Shell Gas Direct stated that having six month auctions for MSEC would ensure that the auction process was held when bidders were in possession of the best available information on gas flows and maintenance for the period for which capacity was sought.

Shell Gas Direct proposed the following timetable for the formula year 2003 /4:

August 2003	MSEC for October 2003 to March 2004 AMSEC for October 2004 to September 2005
September 2003	LTSEC for October 2005 to September 2017
February 2004	MSEC for April 2004 to September 2004

Respondents' views

Of the thirteen responses received to this modification proposal, approximately half of the respondents supported the re-introduction of six month allocations of capacity.

Improved information

The majority of respondents who supported the modification proposal suggested that six monthly auctions would provide participants with greater flexibility, allowing them to bid for capacity based on the most up to date information. Respondents suggested that shippers would be able to better optimise their capacity holdings for the next six months by having a better view of the system demand levels which would be accommodated into their bidding strategies. One respondent commented that it worked on a short-term operational basis and therefore having six monthly

auctions would allow them to change their capacity holdings on a month by month basis with a more accurate prediction of gas capacity requirements. Another respondent stated that the proposal would minimise the opportunity for bidding strategies to be based on information that later turns out to be inaccurate.

Timing of auctions

A number of respondents who opposed the modification proposal suggested that holding an AMSEC in August would add complexity to the current timetable. One respondent suggested that August AMSECs could lead to inefficient capacity capture since bidding in August for the period October (Y) to September (Y+1) is more difficult than bidding in February for the period April (Year Y) to March (Y+1). The respondent stated that this was because little planned maintenance is carried out during winter months. The respondent also stated that holding two six monthly auctions each year would consume shipper time and resources without adding value. With reference to modification proposal 0616, which proposes moving the AMSECs to February, one respondent suggested that this proposal positioned the auction at a time where complete information was most important as there is much greater volatility in the availability of MSEC in the summer period. A number of respondents expressed concern about possible conflicts between modification proposals 0616, 0617 and 0625.

Regime stability

A respondent who did not support the modification proposal suggested that there was a need for some stability and closure within the current new regime before more changes could be introduced. Additionally, one respondent considered that the current 12 month arrangements for monthly capacity sales were a reasonable compromise between the long-term view of LTSEC auctions and the provision of short-term capacity. A number of respondents stated that shippers could fine tune their positions using the current arrangements and under the rolling monthly system entry capacity (RMSEC) auctions. They considered that there was therefore no need for six months auctions.

Changes to transportation charges

Several respondents who opposed the modification proposal were concerned that if Transco were to hold two six monthly auctions this could lead to instability and

consequential changes to charges in order to accommodate any under or over recoveries, with possibly less than two months notice. One respondent considered that there would be no problem with holding additional auctions if the provisions set out in PD 17 were implemented and if Transco still gave two months notice of changes to charges.

Clarification

One respondent supporting the proposal stated that it was unclear if the proposal would remain 'evergreen' and apply to all future auctions. Another respondent in support of the proposal stated that the modification proposed that the six month auction rule only be implemented up to October 2004, at which point the auctions would revert to being held annually. The respondent stated that this would cause unnecessary complexity and uncertainty.

Transco's views

Transco did not support this modification proposal. It recognised that there are some benefits in holding six month auctions but it considered that overall the benefits of regular monthly auctions were outweighed by the additional complexity that would be introduced into the capacity release regime as a result of an increased number of auctions. Transco did not consider that implementing modification proposal 0625 would better facilitate the relevant objectives of its network code.

Timing of auctions

Whilst Transco acknowledged that operating MSEC auctions on a six monthly basis had worked reasonably satisfactorily for a number of years, it considered that a proposal to offer capacity from April (Y) to September (Y) in a six month auction when that capacity had already been offered 18 months before in an AMSEC auction would create uncertainty and complexity in the auction process. Transco stated that the April capacity would have already been offered in the August (Y-2) AMSEC auction. Transco stated that shippers may find it harder to manage their capacity positions given the 18 month gap between the two opportunities to acquire summer capacity under the proposed auction timetable and that the discontinuity in timing may affect the perceived value of MSEC for the April to September period relative to other periods.

Transco also stated that although auction participants might have better information about their own capacity requirements and Transco's maintenance plans ahead of the February MSEC auctions for summer capacity, the proposal would also result in significant quantities of capacity not being sold well in advance of the summer capacity period thereby detracting from the efficiency of the secondary capacity market and impacting upon Transco's own forward contracting activity.

Interactions with modification proposal 617

Transco noted that if implemented, modification proposal 0617 would be incompatible with modification proposal 0625. It stated that if modification proposal 0625 were to be implemented then it would be impossible to calculate the availability of capacity for sale in the LTSEC auctions. It stated that, by way of example, implementation of both modification proposal 0625 and 0617 would imply that the April 2005 to September 2005 period would first be released through the August 2003 auctions and then subsequently released via the September 2003 LTSEC auction. Transco stated that this would create the possibility of different quantities of entry capacity being secured at any ASEP within any calendar quarter, thereby making the calculation of quantities to be offered for sale in the LTSEC auctions impossible.

Changes to transportation charges

Transco agreed with those respondents who suggested that there was a greater likelihood of avoiding mid-year price changes if MSEC is offered on an annual basis. Transco stated that the absence of an early sale of MSEC for the October to March period would increase the uncertainty of the price setting process. It suggested that there would need to be a reduction in the notice period for changes to transportation charges from two months to one month if MSEC auctions were held in February.

Ofgem's views

Ofgem recognises that a number of respondents considered that two six monthly auctions would be beneficial for bidders wishing to fine tune their positions. Whilst we understand this desire, Ofgem considers that adding an additional short-term auction to the current timetable may create some complexity in capacity allocations. The introduction of additional complexity would not better facilitate competition between shippers and suppliers.

Ofgem also notes the views expressed by some respondents that many of the uncertainties associated with purchasing entry capacity relate to the summer period. Having regard to these views, Ofgem would note that the implementation of modification proposal 0616, which provides for February AMSEC auctions should address some of these concerns by enabling shippers to gain access to entry capacity close to the summer period at a time where shippers will have up to date information on matters such as summer maintenance.

Changes to transportation charges

As noted in previous decision letters, Ofgem also considers that it is preferable for transportation charges to be revised once a year only, with sufficient notice being given to shippers of this change. In particular, minimising the number of changes to transportation charges would facilitate competition between shippers and suppliers.

Ofgem notes that it has today implemented modification proposal 0616 which aligns the capacity year with the price control year and provides for AMSEC auctions to occur in February. Ofgem considered that this proposal better facilitates the relevant objectives in so far as it should assist in introducing charging stability by providing Transco with better information regarding its likely revenue flows for the forthcoming price control year.

With this in mind, Ofgem does not believe that it is appropriate to introduce a six monthly auction regime with one auction in August for the October to March period and a further one in February, for the April to September period. As Transco has noted, the absence of an early release of capacity for the October to March period reduces the level of information received by Transco relating to forecast revenues for the formula year and would increase the potential for pricing uncertainty. This would not better facilitate competition between shippers and suppliers.

Ofgem recognises that there is a balance to be achieved between charging certainty and enabling shippers to access capacity close to the period of gas flow. However, we consider that this balance can be better achieved through the implementation of modification proposal 0616 as opposed to modification proposal 0625. Ofgem would note that, to the extent that shippers wish to fine tune their capacity requirements close to the October to March period, shippers are able to access

rolling monthly system entry capacity and daily capacity. Further, entry capacity can also be accessed close to the relevant flow period on secondary markets.

Ofgem's decision

Ofgem has carefully considered the issues raised by this modification proposal in relation to the timing of future AMSEC auctions. For the reasons outlined above, Ofgem has directed Transco not to implement this modification because we do not consider that it would better facilitate the achievement of the relevant objectives as set out in amended standard condition 9 of Transco's GT licence.

If you require any further information in relation to this modification proposal please feel free to contact me on the above number or Tolani Azeez on telephone 020 7901 7043.

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