

OFGEM DECISION LETTER No. 0541
"Inclusion of Unsold Baseline Capacities in Day Ahead Capacity Auctions"
Version 1.0

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/541
Direct Dial: 020 7901 020- 7437
Email: mark.feather@ofgem.gov.uk

28 March 2002

Dear Colleague,

Modification Proposal 0541 '*Inclusion of Unsold Baseline Capacities in Day Ahead Capacity Auctions*'

Ofgem has considered the issues raised in Modification Proposal 0541 '*Inclusion of Unsold Baseline Capacities in Day Ahead Capacity Auctions*'.

Transco raised this proposal on 8 March 2002 and requested that Ofgem grant it urgent status. Ofgem agreed that the proposal merited urgent status in a letter issued on 8 March 2002, after which Transco issued the proposal for consultation. Transco undertook to provide a copy of the final modification report to Ofgem on 22 March 2002. Ofgem received the final modification report on 25 March 2002.

Before proceeding to confirm the decision that Ofgem has reached in respect of this modification proposal, Ofgem considers that it is appropriate to clarify some matters surrounding the modification proposal.

Ofgem notes that some respondents raised the issue that these modification proposals sought prematurely to anticipate the outcome of the statutory consultation process under section 23 of the Gas Act 1986 to introduce changes to Transco's Gas Transporter's (GT) licence associated with Transco's price control for the period April 2002-7. Transco sought to address this perception by noting in its final modification report issued to the industry on 25 March 2002 that the proposed licence amendments in respect of the System Operator (SO) Incentive Final Proposals are to be the subject of a separate statutory consultation under section 23 of the Gas Act 1986 that has yet to be commenced and that no assumptions can be made in respect of the outcome of this process. While this is correct, Ofgem wishes to address any concerns that industry participants may have on this matter.

Any decision placed before the Authority under standard condition 9 (Network Code) of Transco's GT licence has to be assessed against the criteria set out therein having regard to the Authority's (and the licensee's) general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the network code as they exist today - not as they may be in the future as a result of a consultation process which has not yet commenced. There are circumstances where it may be appropriate to have regard to imminent changes to a licence or regulatory regime in order to assess whether the changes meets the relevant criteria. Here it is appropriate to note the existence of

the SO Final Proposals but it is inappropriate to make assumptions about how these could be translated into licence obligations as these have yet to be consulted upon.

However, Ofgem considers it appropriate to confirm that it does intend to publish licence modifications for statutory consultation under section 23 of the Gas Act 1986 and that one possible consequence of that statutory consultation process is that further changes to Transco's Network Code **may** be necessary to implement changes to Transco price control (Transmission Asset Owner (TO) and SO) for the period 2002-07. Ofgem intends to commence this process shortly. It is important to stress that nothing in this decision nor any other document precludes any signatory to the network code raising modifications on this or any other matter in the future.

In reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to facilitate implementation of the SO Final Proposals. This is not possible for the reasons stated above. The basis for considering whether to direct that this modification be made is set out in standard condition 9 of Transco's GT licence. Having regard to the criteria set out there and for the reasons set out in the Ofgem views section of this letter, Ofgem has decided to direct Transco to implement this proposal.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

Allocation arrangements

Transco has allocated monthly entry capacity rights to access its National Transmission System (NTS) through six-monthly auctions since September 1999. In addition to these auctions, Transco also makes firm and interruptible capacity available on a daily basis where there is additional capacity physically available. Capacity is sold at the day-ahead stage and within the gas day. In addition, any unsold capacity from the monthly auctions is available as an 'off-the-shelf' product for purchase up to three days in advance of the beginning of the relevant month.

In the event of a constraint at an entry point (when physical capacity is less than capacity sold against which gas is flowing) Transco can reduce capacity availability by either scaling back interruptible capacity or buying back firm capacity until the constraint is relieved.

Incentives

Transco currently has financial incentives that are designed to ensure that Transco manages the costs of any buy-backs by exposing it to a proportion of any buy-back costs incurred. The incentives are also designed to ensure that it releases all physically available entry capacity to market by selling additional capacity day-ahead and within-day.

Determination of capacity volumes

On 31 January 2001 Ofgem accepted modification proposal 0499, '*Transition Arrangements for Long Term Capacity Allocation*'. This proposal provided that the volumes of capacity to be offered for sale in the February 2002 entry capacity auctions for the period April to September 2002 were to be set at 90% of a series of

baseline entry capacity output measures as defined under Transco's TO price control for the period April 2002-7. *Review of Transco's Price Control from 2002, Final proposals*, September 2001. The NTS TO control baseline entry capacity outputs were set at the maximum physical entry capacity at each entry point to the NTS. The proposal provided for these volumes to be referenced in Transco's Transportation Statement.

In its decision letter Ofgem indicated that basing the release of capacity volumes on a proportion of maximum physical capacity levels represented an improvement on the methodology that had previously been adopted for determining capacity volumes, 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 new gas developments such as new fields or reduced profiles of existing fields.

In its letter Ofgem referred to its concerns regarding the absence of transparency associated with the methodology and the degree of discretion that the methodology accorded to Transco in determining capacity volumes to be offered for sale in the monthly system entry capacity auctions. Ofgem also repeated its views that an approach based on maximum physical capacity levels removes the possibility that scarce capacity is allocated to terminals not on the basis of price but on the basis of an alternative artificial allocation mechanism such as SND. These views were also outlined in Ofgem's decision on Modification Proposal 0481, *'Release of ASEP Maximum System Entry Capacity Volumes for MSEC auction'* which provided for a release based on a proportion of maximum capacity levels for the auctions of capacity relating to October 2001 to March 2002.

The proposal

The modification proposal amends the rules for determining the amounts of daily system entry capacity to be offered for sale via auctions such that it includes any unsold baseline capacity. The unsold baseline capacity will be offered for sale in auctions held at the day ahead stage.

Respondents' views

The majority of respondents supported the proposal. However, many of these respondents qualified their support.

Several respondents supported the principle of unsold baseline capacity being offered for sale at the day-ahead stage. One of these respondents supported the 'top-down' approach contained in Ofgem's SO proposals.

One respondent, while recognising that the proposal may provide greater certainty for shippers, stated that there may still be a need for reconciliation depending on the exact form of any licence amendments. This respondent also expressed disappointment with the delay to the publication of the proposed licence amendments, which it said made it difficult to comment meaningfully on this proposal. These concerns were shared by a number of other respondents, one of whom suggested that shippers have been presented with partial information as a result of an incomplete process which was unacceptable.

Another respondent also indicated that there may be a need for a reconciliation process given that licence obligations had not been agreed.

Another respondent, while accepting that it would not be appropriate to continue with the current regime in the Network Code, was concerned about the risks associated with changing Users' and Transco's systems at short notice. This respondent indicated that the interim proposals raised by Transco add uncertainty to shippers operations.

Several respondents requested clarity on whether any changes implemented by the proposal would be removed from the Network Code once any proposed licence amendments are implemented.

A number of respondents also indicated that there was insufficient understanding amongst industry participants of the revenue flows under the new regime.

One respondent was unclear on how capacity above baseline would be made available to shippers on a short-term basis and was particularly concerned that demand for capacity next winter might be greater than the baseline level at St Fergus.

One respondent did not offer a definitive view on the proposal. This respondent indicated that it had significant concerns regarding the process surrounding the introduction of the SO incentives via modifications to Transco's GT licence. It indicated that it would expect licence conditions to be finalised ahead of the price control period. However, this respondent stated that it is necessary to amend the methodology used to calculate the volume of daily system entry capacity that Transco makes available for sale such that it includes baseline entry capacity.

Two respondents opposed the proposal. One stated that due process required consideration of the proposed licence amendments prior to consideration of this proposal. This respondent felt that it was unable to comment further on the proposal until it could examine the licence proposals. It also felt that it was unacceptable for Transco to seek to introduce changes to the Network Code while it was effectively hedging its own commitment to these changes. The respondent indicated that it was inappropriate for Transco to seek to implement changes to the Code ahead of 'anticipated' licence amendments which have not been resolved or published.

Another respondent also disputed whether a proposal to oblige Transco to sell up to its baseline capacity levels was a part of Ofgem's SO proposals. This respondent also sought clarification on the treatment of any over-recoveries from sales of daily capacity at the day ahead stage and also expressed concern that the proposal may increase the potential for buy-backs and undermine the economic and efficient operation of the pipeline system by increasing risks to shippers.

Transco's view

Transco believes that this proposal is necessary to facilitate the implementation of Ofgem's final proposals in respect of Transco's NTS SO incentive scheme and was raised in anticipation of changes to be proposed by Ofgem through licence amendments. Against this background, while noting that the proposed licence amendments are to be the subject of a consultation under s23 of the Gas Act 1986 and that no assumptions could be made regarding the outcome of that process, Transco stated that the implementation of this proposal would enable it to fulfil its anticipated obligation to offer any unsold baseline capacity at the day-ahead stage and facilitate compliance with the efficient discharge of its GT licence obligations. Transco also stated that implementation of the proposal would provide certainty for

users in the absence of expected changes to its GT licence and would also maximise shippers' access to baseline capacity.

In its final modification report Transco indicates that it believes that Ofgem has indicated in published documents that Transco should be obliged to offer unsold baseline capacity up to and including the day-ahead stage.

Ofgem's view

The inclusion of any unsold baseline capacity in the volumes to be made available for sale at the day-ahead stage will ensure that shippers are able to access baseline capacity levels on a day ahead basis as well as on a monthly basis. This broadens the options which shippers can utilise to obtain access to baseline capacity and provides certainty for shippers as to the minimum levels of capacity that will be released at the day-ahead stage. This should therefore assist shippers in managing their capacity requirements. In this respect the proposal better facilitates the relevant objectives of securing effective competition between relevant shippers and relevant suppliers.

Ofgem considers that it is reasonable to limit the inclusion of unsold capacities in the determination of daily system entry capacity volumes to the day-ahead stage. In this respect Ofgem recognises the concerns that have been previously raised by Transco that it could be in a position of both buying capacity back to manage constraints and selling capacity on the day.

Ofgem does not accept the position outlined by Transco in its final modification report that the changes proposed in this modification would facilitate compliance with the relevant objective of the efficient discharge of Transco's obligations under its GT licence. In particular, Ofgem considers that it is not possible to determine whether the modification better facilitates this objective in circumstances when the proposed modifications to Transco's licence are to be the subject of a consultation that has not yet occurred.

As outlined previously Ofgem intends to issue the consultation on the proposed modifications to Transco's GT licence shortly. Any modifications to Transco's GT licence are therefore subject to this consultation process. Accordingly, it is incorrect to assume that such changes will be implemented and to judge this proposal against Transco's 'anticipated' licence obligations.

As noted previously, any decision placed before the Authority under standard condition 9 (network code) has to be assessed against the criteria set out therein having regard to the Authority's and the licensee's general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the network code as they exist today, not as they may be in the future as a result of a consultation process which has not yet commenced.

Further, as noted above, in reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to facilitate the implementation of the SO Final Proposals. This is not possible for the reasons stated above. The basis for considering whether to direct that the modification be made is set out in standard condition 9 of Transco's GT licence.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco to implement this modification proposal because we consider that it better facilitates the achievement of the relevant objectives as outlined under 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.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements