



Shippers, Transco and other interested parties

Bringing choice and value to customers

Our Ref: net/cod/mod/0651
Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

16 December 2003

Dear Colleague,

Modification Proposal 0651 'Increase the number of rounds in the Annual auctions for MSEC'

Statoil raised modification proposal 0651, *'Increase the number of rounds in the Annual auctions for MSEC'* on 1 November 2003.

Ofgem has carefully considered the issues raised in this proposal and has decided to direct Transco to implement this proposal because we 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 this decision, Ofgem has taken into account Transco's obligations under its GT licence, our wider statutory duties and all relevant facts. The reasons for our decision to direct Transco to implement modification proposal 0651 are set out below.

Background to the proposal

System Entry Capacity Auctions

Transco allocates monthly system entry capacity (MSEC) rights to access the national transmission system (NTS) via annual and rolling monthly auctions. 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 capacity at market determined prices.

MSEC auction processes

Modification 350 '*Auction of monthly system entry capacity and capacity availability*' set out the rules for the monthly auction process. The modification established that the monthly auctions would take place over four rounds with two working days between the close of each round. In each round, one quarter of the available entry capacity would be made available for each of the six months. Any unsold capacity in the first three rounds would then be offered for sale in the fourth round. Reserve prices were set for each terminal and successful bidders paid the price they had bid in the auction.

The original monthly system entry capacity auctions commenced in September 1999 and were designed to auction six months of capacity at six of the major beach terminals to Transco's NTS.¹

Additional system entry capacity allocation arrangements

Following the implementation of modification 0500, '*Long-Term Capacity Allocation*', in September 2002, Transco also makes available quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use. The first long-term auction for the sale of QSEC from October 2004 to September 2017 was held in January 2003, with a subsequent auction occurring in September 2003 for the period April 2005 to March 2020.

Modification 0500 also established Annual MSEC (AMSEC) auctions. These auctions provide a mechanism for Transco to offer for sale any unsold baseline capacity and obligated incremental capacity from the QSEC allocations and (in the case of the allocation one year ahead of the period of use) the 20 per cent of SO baseline capacity that has been held back for release in the short-term in accordance with Transco's GT licence.

¹ The six main beach terminals are St Fergus, Teesside, Theddlethorpe, Bacton, Barrow and Easington.

Under the modification, MSEC would continue to be offered on an annual basis for years 1 to 3 (ie up to October 2004) in a one-round pay-as-bid blind auction, and thereafter, in annual allocations. In Ofgem's decision letter approving modification 0500, we stated that we continued to support the use of pay-as-bid auctions to allocate short-term entry capacity rights, along the lines of the original short-term arrangements. We noted the concerns expressed by a small number of respondents about the use of a single round MSEC auction at that time. However, Ofgem considered that following the completion of any transitional arrangements prior to the physical release of long-term capacity rights from October 2004 onwards, the volume of capacity offered in short-term auctions would be much smaller than the volumes of capacity available in six monthly MSEC auctions. We considered that single round AMSEC auctions would be more appropriate in these circumstances.

The first AMSEC auction was held in August 2003 for the period October 2003 to March 2004 (a transitional period). In this auction, capacity was offered in a pay-as-bid format across four rounds. Following the implementation of modification proposal 0616, *'Revision to the Standard Year for purposes of acquiring and holding Annual Monthly System Entry Capacity'*, the next AMSEC auctions, currently scheduled to occur in February 2004, will offer capacity from April 2004 to March 2005. In this auction, 100 per cent of baseline entry capacity will be offered for the first six months (April 2004 to September 2004) as this capacity has not been offered in any previous allocation.

The proposal

Statoil has proposed to increase the number of rounds over which annual MSEC auctions operate from one to four. Statoil suggested that the implementation of this proposal would increase the level of price discovery in the auction process and would also increase the number of opportunities for securing system entry capacity.

Respondents' views

Of the twelve responses received to this modification proposal, all of the respondents supported increasing the number of rounds over which the annual MSEC auctions operate from one to four.

Effect on price discovery, market information and price levels

Most respondents argued that the implementation of this proposal would increase the level of efficient price discovery and provide participants with more opportunities to secure capacity. A number of respondents commented that the

significant amounts of capacity on offer for April 2004 to March 2005 justify a four-round auction. Some respondents commented that increasing the number of rounds over which the auctions operate would reduce the likelihood of high prices and potential over-recoveries by Transco, thus improving the stability of annual transportation charges.

Number of rounds in later auctions

A number of respondents stated that they would prefer to hold four round AMSEC auctions on an enduring basis.

One respondent stated that the proposal should only be implemented for the auctions for April to September 2004, during which period 100% of baseline capacity is auctioned.

Other respondents suggested that a modification proposal might be raised in the future, so that the number of rounds could be reduced in AMSEC auctions where a smaller amount of capacity is offered. Among these respondents, a number stated that it may be more appropriate to reduce the number of rounds if the current 20% hold back of capacity is eventually removed.

Consequences of not implementing the proposal

Some respondents noted that a single round auction could result in higher clearing prices, since shippers, with a single opportunity to fulfil their capacity requirements, might tend to increase the prices they bid at.

One respondent underlined the possibly detrimental effects of “distortions to the price signal through artificial constraints or panic inducing sales methods” generated by single round auctions. This respondent indicated that this would increase risks, discourage new entry and reduce competition.

One respondent stated that in recent auctions, Transco had scaled back demand in long-term auctions in a number of quarters, indicating that it is likely that there will be demand for the 20% held back. Therefore, the respondent believed that a single round auction might result in inefficiently high prices and an over-recovery by Transco.

Another respondent suggested that with a single round AMSEC auction shippers may fail to capture the capacity they need. Therefore, there would be an increased

probability that gas would be stranded offshore, which might have an impact on gas flows into storage next year and possibly increase wholesale gas prices.

Transco's views

Transco offered support for the proposal. It considered that increasing the number of rounds in the AMSEC auctions would better facilitate the relevant objectives of its network code. In particular, it considered that the proposal would better facilitate the securing of effective competition between shippers, by providing more information to the market.

Effect on price discovery, market information and price levels

Transco agreed with respondents that this modification proposal allows shippers to obtain more information in terms of the volume and price of capacity demanded, and provides shippers with a greater number of opportunities to secure capacity.

Transco noted shippers' concerns regarding a possible over-recovery and its negative impact on the stability of transportation charges. However, it considered that in auctions where reduced volumes of capacity are offered, the effect would be minor.

Number of rounds in later auctions

Transco noted the preference expressed by some shippers on retaining four-round AMSEC auctions when the capacity on offer will be limited, but it stated that it was not convinced of the merits of this view given the smaller quantity of capacity expected to be released in later AMSEC auctions.

Consequences of not implementing the proposal

Transco stated that in later AMSEC auctions, as a result of shippers having had earlier opportunities to secure their entry capacity requirement, the potential for high prices will be reduced. Transco did not agree with one respondent's view that gas could potentially be stranded offshore if a single round AMSEC auction was retained, given that the quantity on offer is the same and shippers have further opportunities to acquire entry capacity through daily capacity processes.

IT development implication and administrative costs

Transco considers that entry capacity auction IT systems have enough flexibility to operate multiple auction rounds. Transco estimated the operating costs associated with the administration of additional rounds to be insignificant.

Ofgem's views

Ofgem notes the wide consensus of support that shippers have shown for this modification proposal on the basis that increasing the number of rounds over which the next AMSEC auctions are held from one to four would be beneficial as it allows better price discovery.

Ofgem notes that based on the experience of previous MSEC auctions there is some evidence of price discovery across multiple rounds. Ofgem agrees with respondents' views on this issue and considers that the February 2004 AMSEC auctions should operate over four rounds, owing to the large volume of capacity on offer. Ofgem also recognises that there is no market information available for the period April to September 2004 as there has been no long-term entry capacity auction in respect of these months. On this basis we consider that a four-round approach will better facilitate competition between shippers and suppliers, by providing more information to the market, thus promoting price discovery and ensuring efficient allocations of entry capacity.

Nevertheless, as stated in Ofgem's decision letter on modification 0500, we consider that where the volume of capacity offered is much smaller, as will be the case in later auctions, a single round auction might be more appropriate. Further, Ofgem considers that the long-term auctions will give market participants the possibility to gain a better understanding of the market value of capacity on offer in AMSEC auctions, thereby reducing the need for multiple round AMSEC allocations. In this context, it is open to shippers to raise separate modification proposals, if they consider it would be appropriate to hold fewer rounds in future AMSEC auctions.

Ofgem's decision

Ofgem has carefully considered the issues raised by this modification proposal. For the reasons outlined above, Ofgem has directed Transco to implement this modification proposal because we 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. In particular, we consider that this proposal will better facilitate effective competition between relevant shippers and suppliers by

increasing price discovery in relation to the sale of system entry capacity, which will be offered to shippers in the February 2004 AMSEC auctions.

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 and Matteo Guarnerio on telephone 020 7901 7043/7493.

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