



Shippers, Transco and other Interested Parties

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to customers*

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Dear Colleague,

**Modification Proposal 0667 'Allocation of Incremental System Entry Capacity at System Entry Points with Descending Price Schedules'**

Transco raised modification proposal 0667 '*Allocation of Incremental System Entry Capacity at System Entry Points with Descending Price Schedules*' on 13 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 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.

We have set out below the reasons for our decision to direct Transco to implement modification proposal 0667.

**Background to the proposal**

The modifications introduced into Transco's GT licence in September 2002 (effective April 2002) introduced the separation of the regulation of Transco's role as Transmission asset owner (TO), where it builds and maintains the network, from its role as National Transmission System (NTS) system operator (SO), where it operates the system on a day-to-day basis and determines the need for additional capacity.

In respect of NTS entry capacity, Transco is funded under its TO function to provide specified TO baseline output measures of entry capacity at each existing entry terminal to its NTS. Under its GT licence, Transco must offer for sale SO baseline output measures, which it does through a

series of long-term and shorter-term entry capacity auctions. The SO baseline output measures are set at 90 per cent of the TO baseline output measures at each specified terminal.

#### *Incremental entry capacity incentive*

Transco's GT licence includes an entry capacity investment incentive scheme which, for a defined period, potentially allows it to earn a higher rate of return (based on ex-ante agreed unit cost allowances (UCAs)) on obligated incremental entry capacity offered for sale above its SO baseline output measures. This incentive is designed to encourage Transco to respond to changes in the levels and locations of demand for entry capacity to its NTS.

#### *Long-term entry capacity auctions*

Following Ofgem's approval of modification 0500, 'Long Term Capacity Allocation', Transco makes available the SO output measures through auctions of 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 2004 to 2017 was held in January 2003, with a subsequent auction occurring in September 2003 for the period April 2005 to March 2020. The next long-term auction is scheduled for September 2004.

#### *Pricing schedules*

Shippers are invited to bid against a set of prices for the quantity of entry capacity they wish to acquire at each terminal in each available period up to 15 years in advance. Transco applies reserve prices (set equal to the UCAs), 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) statement.

#### *New entry terminals*

Following the conclusion of Transco's 2002-2007 price control review, a number of parties approached Transco with proposals to bring additional gas supplies into Transco's NTS through proposed new LNG terminals at Milford Haven and with proposals to develop storage facilities. Consequently, Transco published indicative price schedules for new entry terminals at Milford Haven and Barton Stacey. The price schedule for Milford Haven was downwards sloping, reflecting the economies of scale associated with the provision of incremental capacity at this location.

Transco also recently issued an update to the Gas Transportation Charges Statement, in which an addendum to Appendix 2E provided details of the step prices for a new ASEP at Garton for use in forthcoming QSEC auctions. The price schedule issued for Garton is downward sloping.

### **The proposal**

Transco argued that the application of the existing network code rules (section B2.6) in the case of downward sloping price schedules may potentially lead to an inefficient allocation of resources, with inappropriately low volumes released. Transco has proposed an amendment to the network code in order to account for this problem. In particular, it proposed to amend the

Network Code section B 2.6.5 (b), by changing the definition of “relevant step price group” for terminals in which a descending price schedule has been published.

### **Respondents’ views**

There were six responses to this modification proposal, and respondents offered unanimous support.

Most respondents noted that the implementation of this proposal would have positive effects on auctions at terminals with descending price schedules. In particular, they stated that capacity allocations would be maximised and appropriate investment signalled would be offered to Transco.

Some respondents shared concerns that if this modification proposal was not implemented, it could potentially result in an inefficient allocation of capacity and it could have distortional effects on costs and revenues, creating disincentives to use the system. One respondent noted that under the current rules there is the possibility that shippers who bid for capacity at lower unit prices may not have their volumes considered.

One respondent expressed its concern about the legal text supplied with the draft modification proposal, claiming that it was unsure whether it correctly delivers the intent of the proposal in the defined circumstances.

Another respondent noted that, although it is not clear that the proposal deals completely with the changes required in order to obtain an efficient allocation of capacity in terminals with descending price schedules, it represents a clear improvement over existing arrangements.

### **Transco’s views**

Transco, as proposer, offered support to the implementation of this modification proposal. Transco noted that under the current network code rules an inappropriately low volume of capacity could be released at ASEPs with descending price schedules. Transco stated that the implementation of this modification proposal would better facilitate its relevant objectives, particularly in terms of the economic and efficient operation of its pipeline system. Moreover, Transco noted that, if implemented, this modification proposal could be seen to better facilitate competition between shippers.

Transco also suggested that without the implementation of this modification proposal there would be an increased possibility that it would not be able to act upon the appropriate market signals, resulting in increased costs to shippers and restricted access to entry capacity.

Transco welcomed the support of all respondents for the modification proposal. It noted the views of one respondent who stated that they are not clear that the proposal deals with all the changes required to allow efficient auctions and investment for bids placed on descending price schedules. However, Transco underlined that it believes the proposal does meet the requirements to maintain and operate an economic and efficient pipeline system.

Transco also noted the concern of one respondent in relation to the legal text, although, since there was no specific detail on which to comment, Transco reiterated its view that the legal text reflects the requirements of the proposal.

## **Ofgem's views**

Ofgem agrees with Transco's view that the application of current network code rules may lead to an inefficient allocation of capacity. We also recognise that respondents offered unanimous support for this modification proposal.

Ofgem agrees with respondents who stated that the proposed modification, by introducing a section in the network code (2.6.5 (b)(ii)) which refers specifically to downward sloping price schedules, contributes towards maximising capacity and obtaining a more efficient allocation of capacity in auctions at terminals with decreasing price schedules.

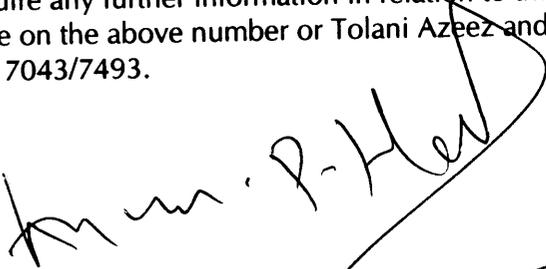
Ofgem considers that this proposal will better facilitate Transco's efficient and economic operation of its pipe-line system and, potentially, will secure effective competition between relevant shippers by introducing a mechanism to allow shippers to bid effectively for system entry capacity at (new) entry terminals where Transco has produced a downward sloping price schedule. Ofgem considers that effective bidding 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.

Whilst we acknowledge that there may be some additional and unidentified issues associated with the provision of entry capacity at terminals where there is a downward sloping price curve, Ofgem considers that this modification proposal and the associated legal drafting fulfil the intention of allowing shippers to bid at terminals such as Garton and Milford Haven.

## **Ofgem's decision**

Ofgem has carefully considered the issues raised by this modification proposal in relation to the allocation of incremental system capacity at entry points with descending price schedules. 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.

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 0207 901 7043/7493.

  
Kyran Hanks  
Director, Gas Trading Arrangements