

OFGEM DECISION LETTER No. 0638
"Extended LTSEC Auctions at New Entry Points"
Version 1.0

Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification proposal 0638 'Extended LTSEC Auctions at New Entry Points'

Transco raised urgent modification proposal 0638 '*Extended LTSEC Auctions at New Entry Points*' on 7 July 2003. Ofgem granted urgency to this proposal on 8 July 2003. We considered that since this proposal was linked to the next long-term auctions, urgent procedures were necessary in order to consider it in time for possible implementation for the September 2003 long-term auctions.

Ofgem has carefully considered the issues raised in this proposal and the responses received and has decided to direct Transco to implement this proposal because we consider that it will better facilitate the relevant objectives of Transco's network code as set out under standard condition 9 of its 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 this modification proposal.

Background

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 allocation

The long-term auctions of entry capacity introduced under modification 0500 '*Long-term capacity allocation*', in September 2002, combined with Transco's entry capacity investment incentive, were designed to introduce improvements to Transco's investment planning process. The long-term sale of entry capacity rights, supplemented by subsequent trading of entry capacity rights in secondary markets, provide Transco with a reliable indication of the demand for entry capacity at different locations on Transco's NTS.

The first long-term system entry capacity (LTSEC) auction was held in January 2003. A second auction is scheduled for September 2003 and will offer quarterly system entry capacity from 2005-2018.

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 has published indicative price schedules for new entry terminals at Milford Haven and Barton Stacey. The price schedule for Milford Haven is downwards sloping, reflecting the economies of scale associated with the provision of incremental capacity at this location.

Transco states in its IECR statement that it needs approximately a three year lead time from receiving a demand signal to being able to provide new entry capacity. This lead time reflects a number of processes, such as determining the pipeline route, tendering for the provision of the pipe, ordering steel, acquiring land and construction.

In June 2003, Ofgem issued a consultation and explanatory document on new entry terminals to Transco's NTS¹ *New entry terminals to Transco's National Transmission System Ofgem's views on Transco's proposals and explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence*, Ofgem, June 2003. The consultation under section 23 of the Gas Act, sought to amend Transco's GT licence to include new UCAs for Milford Haven and Barton Stacey. This consultation was accompanied by an explanatory document on new entry terminals to Transco's NTS. Ofgem is currently considering responses to our June licence consultation document. As part of this consultation, Ofgem stated that in view of the different project timescales for the main parties interested in acquiring capacity at specified new entry points, Transco and / or shippers may consider it appropriate for Transco to operate an open season for capacity bids. An open season would extend the time period in which parties could signal their demand for capacity at a specific terminal, in order for Transco to take aggregate demand signals into account in investing to provide new entry capacity.

Ofgem recognised that there would be costs associated with Transco operating an open season. We therefore stated that it would seem reasonable that any new open season arrangements could accommodate an option fee that reflected the associated costs, and that such a fee could be refundable in the event that a party participated in an open season auction.

Ofgem anticipated that an open season could possibly operate from the time of the nearest scheduled long-term auction for all existing terminals until the time at which Transco needed to commit to ordering pipe and determining a certain pipe route. We also suggested that a number of auctions could be held during an open season (subject to the necessary changes being made to Transco's network code), with bidders facing the same price schedule for the specified new entry terminal throughout the period.

After each auction held within the open season, Ofgem suggested that Transco could allocate capacity to satisfy the volume bid against its price schedule at a known maximum price to those participants bidding at the specified terminals. The release of such incremental capacity would be subject to Ofgem's approval of an application made by Transco to release incremental capacity on the basis of the criteria as set out in its IECR.

At the end of the open season, Ofgem envisaged that Transco could aggregate the demand signals received in the auction(s) and could use these signals to determine its incremental capacity release decision. Those shippers who had bid for and were allocated capacity would then pay a common cleared price for the capacity.

Preliminary Works Agreements

Transco may require a party requesting a network extension (or connection) to the NTS to enter into a preliminary works agreement (PWA). PWAs may be entered into in order for Transco to identify in more detail the scope of any specific reinforcement (enhancements) to the system that may be necessary to meet a requested gas load or to progress a pipeline project from the feasibility stage to the design and build phase. In general, the scope of a PWA may cover specific detailed investigations, environmental impact studies or archaeological surveys. Parties who enter into a PWA are required to pay a refundable fee in advance of purchasing capacity.

Modification proposal 0622 'Long term system entry capacity for new entry points'

Transco raised modification proposal 0622 on 17 March 2003. Under the proposal, there would need to be 100 business days between the first day of the annual LTSEC and any additional LTSEC auctions, following the publication of price schedules for entry capacity at new ASEPS. Ofgem will be publishing its decision on this proposal shortly.

The proposal

Transco proposed that the network code should be amended such that an extended auction for quarterly system entry capacity (QSEC) offered at new NTS aggregated system entry points (ASEPs) can be operated at an interim (initial) and final stage. The proposal would introduce the following modifications to the current (QSEC) arrangements:

- an extended auction would consist of an interim (initial) and final stage;
- the prices, once published, shall remain unchanged for the period of both the interim and final stages of an extended auction;
- the date for completion of the final stage shall be signalled at the time of the initial invitation to auction and a reminder will be issued not less than 28 days before the final stage is due to start;
- bids cannot be withdrawn following completion of the interim and final bid stage;
- Transco's capacity determination after the final stage results will be based upon the price indicated at the final stage;
- following an interim stage of an extended auction Transco will notify bidders of their final allocation volumes at that stage and provisional allocation prices;
- following completion of the interim (or where appropriate final) stage Transco will determine the allocation of capacity, taking into account the aggregate of the bids placed during the interim stage and bids placed in the final stage; and
- an extended auction arrangement shall not apply in respect of an ASEP where no capacity had been allocated at the interim stage.

Respondents' views

There were six responses to this proposal. All respondents supported the proposal although a number of them expressed concern and requested clarity in relation to the operation of the extended auction process.

Improved investment signals

Respondents considered that this proposal offered benefits to shippers and to Transco. They noted that the proposal would ensure that optimum and efficient investment is carried out on the basis of the best possible information about future network developments. One respondent stated that the proposal would avoid the additional cost of building multiple pipelines. Several respondents commented that the proposal would enable shippers to take advantage of economies of scale.

A small number of respondents considered that standard format LTSEC auctions would not necessarily deliver appropriate and efficient long-term signals, particularly where there were a potential number of developers with different time scales. One respondent considered that there was a possibility that the extended auction window for a specified new terminal would not be long enough to allow all parties to reveal their demand for capacity. In this context, the respondent also stated that the long-term auction process by itself was insufficient to drive investment programmes and that maybe therefore there would be a need for a wider application of the proposal to existing ASEPs.

One respondent considered that the principle of applying decreasing unit costs as the capacity quantity ascended should be extended to other terminals and that Transco would be discriminating by not widening the proposed rule.

However one respondent commented that there should not be a general application of the proposed extended auction arrangements for all ASEPs. It argued that the proposal was only applicable and would only deliver efficiencies where the initial price curve slopes downwards and where the investment decreases with increasing pipeline diameter and increased capacity requirements (ie at new terminals).

Timing of the auctions

Respondents in general considered that, if implemented, extended auction arrangements should take effect from September 2003. One respondent commented that while it may be appropriate to issue invitations for a secondary auction not later than 30 September, it is possible that auctions at new entry points may take place on other dates and therefore it may be more appropriate to issue an invitation for a secondary auction at a fixed time period after the auction.

While several respondents considered that it was appropriate for Transco to halt the extended auction period for a new ASEP if no bids were received in the initial auction, some respondents suggested that Transco should have a firm commitment to hold a secondary auction.

Option fees

A number of respondents considered that although the proposed concept was reasonable, there was insufficient detail about the operation of the extended long-term auction and the use of an option fee for new ASEPs. Respondents wanted further information about:

- a. how the option fees would be determined;
- b. whether the option fees would reflect the terms of a pre works agreement;
- c. when the option fee would be collected;
- d. how any revenue from option fees would be dealt with through Transco's price control.

- e. the credit requirements on option fees; and
- f. whether the option fee would cover administrative costs or the additional risks and / or costs faced by Transco in keeping options of pipeline size open.

One respondent also expressed concern that Transco's legal drafting did not place an obligation on Transco to call a secondary capacity bid auction during the open season even if an option fee had been paid.

One respondent suggested that the auction invitation letter should state the date by which commitments from shippers to underwrite the costs of a first extension phase should be received. This respondent stated that the latest date for the receipt of these payments should be a date following the allocation of capacity after the interim auction.

Transco's views

Improved investment signals

Transco supported the implementation of this proposal. It considered that the proposed arrangements would deliver an efficient solution for the sizing of onshore infrastructure at new entry points, which would benefit Transco, upstream developers and system users. Transco considered that the purpose of the proposal was to enable an efficiently sized pipeline system to be developed to provide capacity for new ASEPs.

Transco welcomed the support of respondents for the principle of extended auctions. It considered that the proposed extended auction arrangements should only apply to new entry points with a downward sloping price curves and should not, at this stage, apply to all ASEPs. Transco stated that it is at new entry points where benefits should be realised through economies of scale. Transco stated that the latest date for commitments should be a date shortly after the allocation of capacity in the initial auction.

Option fees

Transco considered that the option fees should cover the potential risk and or additional costs that Transco may face in extending the auction period and extending its pre-construction planning and timetable. Transco also considered that the pricing methodology for the option fees was outside of the remit of the network code and that the pricing calculation would be shared with the relevant parties and with Ofgem. In response to respondents' concerns, Transco considered that the treatment of the revenue from option fees would be agreed with Ofgem under Transco's price control formula. It also stated that the revenue would be refundable against any capacity payments or refunded in the event that an extended auction did not take place because there was no capacity allocation in the initial auction.

Transco's final proposal

In its final modification report Transco clarified that the criteria for setting an extended auction would be the allocation of capacity in the initial stage of the auction and the payment of option fees.

The final modification report set out some amended legal drafting which clarified that the decision to proceed with an extended auction would not be limited to a 30 September deadline and confirmed that proposal 0638 accommodates the potential implementation of modification proposal 0622.

Ofgem's views

Ofgem agrees with the views expressed by Transco and respondents that the proposal should facilitate efficient incremental entry capacity release and network investment decisions at new terminals by enabling auction information to be aggregated over a longer period. The aggregation of this information should assist in the realisation of the benefits of economies of scale associated with investments at new terminals.

For example, the application of this modification proposal at Milford Haven will allow potential bidders to reveal their demand, prior to Transco's commitment to build and will better inform Transco's long-term investment decisions.

Ofgem considers that by facilitating efficient network investment the proposal should better facilitate efficient system operation and competition between shippers and suppliers.

Ofgem recognises the concerns raised by respondents with regard to the detailed framework for the application of option fees. As set out in our June 2003 document, Ofgem envisages that Transco will agree the appropriate range of option fees with Ofgem and shall publish these details together with dates for the open season within its auction invitation letter or prior to the auctions, in order to provide due transparency to the process.

Whilst Ofgem acknowledges that some shippers may not be able to take advantage of an extended auction season at a particular terminal within Transco's specified auction window, we consider that an extended auction season must close at some stage in order to allow Transco to begin timely construction of new extensions and any necessary reinforcement work. Ofgem considers that Transco's procedures for calling a secondary auction and the period of time for holding an extended auction period, as set out in its revised legal drafting, are flexible in order to reflect the particular circumstances of different projects.

Ofgem envisages that these procedures should accommodate new entry terminal investment requirements on a case by case basis.

Ofgem continues to consider that the signals for incremental capacity revealed in the long-term capacity auctions will improve Transco's ability to make long-term network investment decisions.

Ofgem's decision

Ofgem has carefully considered the issues raised by respondents and Transco in relation to this modification proposal. We consider that this modification proposal will better facilitate the achievement of Transco's relevant objectives as set out under amended standard condition 9 of its GT licence. In particular, the development of the current long-term capacity allocation arrangements to accommodate new entry terminals and the project timescales of developers will

enhance investment decisions for Transco. This will better facilitate the efficient and economic operation of the pipeline network and will also encourage effective competition between relevant shippers and relevant suppliers.

If you require any further information in relation to this modification please feel free to contact me on the above number or Tolani Azeez on telephone 0207 901 7043.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M Feather', is positioned above the printed name.

Mark Feather
Head of Gas Trading Arrangements