



Shippers, Transco and Other Interested Parties

*Bringing choice and value to customers*

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Dear Colleague,

**Modification Proposal 0630 'Zero Reserve Price for Within-day Sale of Daily System Entry Capacity'**

Transco raised modification proposal 0630 '*Zero Reserve Price for Within-day Sale of Daily System Entry Capacity*' on 15 May 2003.

Ofgem has carefully considered the responses to this proposal and has directed Transco to implement this proposal because we consider that it will better facilitate the achievement of the relevant objectives as set out under standard condition 9 of Transco's Gas Transporter's (GT) licence.

In making this decision Ofgem has taken into account the obligations set out in Transco's 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.

**Background**

*System entry capacity and Transco incentives*

Transco allocates entry capacity rights to its National Transmission System (NTS) through a series of long and short term auctions. Under the entry capacity regime established in Transco's GT licence, Transco is funded to provide a series of baseline output measures of entry capacity for each system entry point. These baseline output measures are based on the maximum physical capability at each system entry point and are referred to as Transco's transmission asset owner (TO) baseline output measures. Transco is obliged to offer 90 per

cent of these output measures (system operator (SO) output measures) for sale as entry capacity rights.

Under its GT licence, Transco has an SO entry capacity investment incentive, which enables it to earn higher rates of return on the sale of obligated incremental entry capacity rights. These rights are additional to the SO baseline output measures, and can be released where there is demand for such capacity signalled in auctions and following an application by Transco, under its GT licence, to Ofgem demonstrating that it has met the criteria for the release of this capacity as set out in its Incremental Entry Capacity Release statement.

Under its licence, Transco has an obligation to ensure that any obligated entry capacity (including baseline and obligated incremental entry capacity) is offered for sale in at least one clearing allocation. This obligation is defined as an allocation where either the capacity is sold or in which the reserve price is zero (subject to Transco's wider network charging licence obligations).

### *Entry capacity auctions*

Following Ofgem's approval of modification 0500, '*Long-Term Capacity Allocation*', in September 2002, Transco makes available the SO output measures through auctions of quarterly system entry capacity (QSEC) rights that enable shippers 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. Following implementation of modification 0617 '*Revision to the Standard Year for purposes of acquiring and holding Long-term System Entry Capacity*' the next long-term auction is scheduled for September 2003, auctioning capacity from 2005 to 2018 in alignment with the April to March capacity year.

Transco has also allocated monthly system entry capacity (MSEC) rights via six monthly entry capacity auctions since September 1999. From February 2004, Transco will be conducting annual MSEC auctions offering MSEC for the capacity years April (Y) to March (Y+1).

In addition to releasing MSEC on an annual basis, Transco also conducts rolling MSEC auctions shortly before the commencement of each month and releases firm and interruptible capacity on a daily basis where there is additional capacity available. Auctions of daily firm system entry capacity ('DSEC') are held on a day-ahead and within-day basis.

Transco also releases a use-it-or-lose-it ('UIOLI') interruptible capacity product on a day-ahead basis. This product is intended to prevent the hoarding of firm entry capacity by shippers. The volumes of UIOLI capacity are determined as the amount by which the holdings of firm entry capacity exceed Transco's estimate of aggregate nominated flows at each terminal.

To the extent that Transco is unable to accommodate expected flows against firm entry capacity rights at a system entry point, Transco must buy back these rights at market determined prices. It has an SO incentive to minimise the costs of buy-back actions.

### *Reserve prices*

Prior to the review of Transco's Price Control for the period April 2002-7, Transco set reserve prices for short-term allocations of NTS MSEC on the basis of its long run marginal cost (LRMC) methodology. The reserve prices were set at 75 per cent of the LRMC levels

following the methodology as set out in Pricing Consultation (PC) 48 '*Methodology for Determining Floor Prices for Auctions of Monthly System Entry Capacity*'. Following the implementation of PC 62 '*Daily System Entry Capacity Floor Prices*,' the reserve prices for DSEC have been set at two-thirds of the level of the MSEC reserve prices.

In November 2002 Transco raised PC 76 '*Transco's proposal for NTS TO Entry Capacity Auction Reserve Prices and Exit Charges*.' Under PC 76, Transco proposed that MSEC reserve prices should be equal to the baseline price for capacity offered in the QSEC allocations and that DSEC reserve prices would be set at two thirds of the level of the QSEC prices. Transco proposed that from October 2003, zero reserve prices would apply for sales of firm system entry capacity made available on the day of use, while the reserve prices for DSEC sales made at day ahead stage would remain at two thirds of the MSEC reserve prices.

Ofgem decided not to veto pricing consultation PC 76.

## **The Proposal**

Transco proposed that the network code should identify that two separate reserve prices would apply for allocation of DSEC from 1 October 2003 following the implementation of PC 76. The established reserve price methodology (as summarised above) would continue to apply for reserve prices that form part of any DSEC allocation at the day-ahead stage (gate closure before 06:00 a.m.) when the allocation is conducted at day ahead rather than at the within-day stage. A reserve price of zero will be applied when a DSEC allocation is conducted at 06:00 on the day or at any time during the gas day.

## **Respondents' views**

Three responses were received in relation to this proposal. All respondents supported the proposal, although one of those respondents offered qualified support. One respondent considered that the proposal would fulfil the requirements of PC 76 and optimise Transco's entry capacity allocation. Another respondent commented that the proposal would promote the effective allocation of entry capacity within day.

One respondent considered that it was appropriate to recognise that DSEC has a different value to shippers dependent upon the timing of the acquisition and therefore it would be appropriate to apply a zero reserve price on capacity sold within day.

This respondent considered that Transco's revenue may be adversely affected should users wish to rely on within-day DSEC for their capacity requirement rather than secure capacity through other auctions. The respondent commented that in an extreme situation this could require a revenue adjustment via the proposed TO commodity charge. However the respondent noted that, by relying on DSEC, a shipper would be subject to the risk of entry capacity not being available on the day. As such, the respondent did not believe that there would be any major impacts on Transco's revenue.

One respondent, providing qualified support, raised concerns regarding the impact of the proposal on Transco's revenue and the increased risk of buy-back costs. The respondent stated that it did not foresee that the quantities of entry capacity to be sold within-day as significant enough for the proposal to have a substantial impact upon Transco's revenue recovery. The respondent stated that it hoped that the industry would keep a close eye on

the implications for other reserve prices to ensure that entry capacity charges are not subsidised by customers as a result of increased transportation costs.

### **Transco's views**

Transco supported implementation of the proposal as it would enable it to satisfy the requirements of its pricing methodology and to discharge its obligations under its GT licence. It commented that the proposal would enable it to optimise capacity allocation and would better facilitate shipper access to system entry capacity thereby better facilitating competition between shippers.

It noted that there was a potential for users to defer purchasing capacity so as to be able to take advantage of a zero reserve price. Transco considered that limited levels of competition might be one factor that would lead shippers to defer bidding in the expectation that capacity could be gained at or close to the reserve price on the day. However, Transco considered that the likelihood and impact of reduced revenue arising from entry capacity sales would be minimal. It suggested that most shippers would continue to demand the majority of their entry capacity requirements well in advance of the gas day.

### **Ofgem's views**

As set out in Ofgem's PC 76 decision letter, Ofgem has consistently stated that reserve prices are only necessary in order to address competition concerns. We continue to consider that reserve prices could prevent all capacity from being released to market. If entry capacity remains unsold or only sells at reserve prices this could suggest that reserve prices are preventing the market from clearing.

Ofgem considers that the introduction of zero reserve prices for within-day capacity will allow the market to clear and enable price discovery at entry points thereby better facilitating competition between shippers and suppliers. Further, the introduction of zero reserve prices also ensures the removal of price differentials between terminals on the gas day thereby facilitating competition for capacity between terminals. The removal of these differentials should therefore also better facilitate competition between shippers and suppliers.

Ofgem would note that in setting zero reserve prices for within-day sales, Transco will still be subject to its licence obligation to avoid undue preference in the supply of transportation services.

Ofgem notes that some respondents have raised concerns regarding the potential impact of this proposal on Transco's revenue. Ofgem however considers that there is sufficient competition for entry capacity at the majority of beach terminals in the short term auctions to guard against any significant revenue under-recovery.

### **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. In particular, Ofgem considers that the removal of within-day reserve prices should better facilitate the securing of effective competition between relevant shippers and relevant suppliers.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Tolani Azeez (tel 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**