



Shippers, Transco and Other
Interested Parties

*Bringing choice and
value to customers*

Our Ref: net/cod/mod/0589
Direct Dial: 020 7901 7021
Email: kyran.hanks@ofgem.gov.uk

Dear Colleague,

Modification Proposal 0589 'Revisions to entry capacity overrun charges ahead of next auctions'

AEP raised modification proposal 0589, '*Revisions to entry capacity charges ahead of next auctions*', on 30 September 2002.

Ofgem has considered the issues raised in this modification proposal and the responses received and has decided to direct Transco not to implement the proposal because we do not believe that it would better facilitate the relevant objectives of Transco's network code. We have set out our reasons for this decision below.

Background

When the new gas trading arrangements were introduced in 1999, one of the fundamental elements of the regime was the 'ticket to ride' principle. This principle is that shippers should acquire entry capacity rights to cover their flows of gas onto Transco's National Transmission System (NTS) and that there should be no incentive for a shipper to flow gas in excess of its entry capacity rights ('overrunning'). At that time,¹ we did not believe that there should be separate overrun charge regimes depending on whether or not the terminal is constrained.

The overrun charge was set at the highest of:

- 1.1 * the highest bid price accepted at D-1 in the daily entry capacity auction;
- 1.1 * the highest offer price accepted at D-1 in the buy-back market daily;
- 8 * the daily rate for Monthly System Entry Capacity (MSEC); and
- 1.5 * the System Average Price (SAP) for gas.

Since the introduction of overrun charges, there has been continuing debate about whether the charge is too high. Following implementation of modification 0408, '*Review of Entry Overrun Charges*' in July 2000, the energy component of the overrun charge was removed and the overrun charge was amended to be set at the highest of:

¹ '*The New Gas Trading Arrangements: A decision document*', Ofgem, September 1999.

- 1.1 * the weighted average price (WAP) by volume of the top 25% of accepted bids for daily capacity;
- 1.1 * the highest accepted offer price at D-1 in the buy-back market; and
- 8 * the daily rate for MSEC (based on the WAP of the top 50% of accepted bids).

In accepting the proposal, Ofgem reiterated its support for the ticket to ride principle and also stated that consistent overrunning could be in breach of the Gas Shippers' licence. In particular, we stated that there was a strong rationale for having terms linked to the prices paid during the primary capacity release and that it should never be cheaper to overrun than to buy capacity. We also accepted the continued need for a term linked to Transco's costs of managing entry capacity constraints.

In November 2001, Ofgem published the results of its investigation into shipper conduct in the capacity market in October 2000. One aspect of the investigation was whether any shippers had been consistently overrunning. While we did not find any evidence of deliberate overrunning, we again confirmed our support for the ticket to ride principle and stated that overrun charges are designed to provide shippers with strong commercial incentives to purchase capacity before flowing gas and ensure that the costs to the system of a participant overrunning are targeted back to that shipper.

Following the implementation of modification 0500, *'Long Term Capacity Allocation'*, the first allocations of long-term entry capacity rights will be held in January 2003, as well as shorter-term allocations leading up to the gas day. As part of modification 0500, the overrun charge was amended to the highest of:

- 8 * the highest accepted bid price for firm entry capacity in any of the forms of allocations Transco holds;
- 1.1 * the WAP by volume of the top 25% of accepted capacity surrender offers;
- 1.1 * the WAP by volume of the top 25% of accepted capacity forward contracts; and
- 1.1 * the WAP by volume of the top 25% of exercised capacity option contracts.

In accepting modification 0500, Ofgem supported reflecting Transco's increased use of capacity management tools such as forward and options contracts in the overrun charge, but considered that the method by which overrun charges are derived should ultimately be set out in the System Management Services Adjustment Data methodology described in special condition 27 of Transco's Gas Transporter's licence.

The proposal

This modification proposal would amend the entry capacity overrun charges, with effect from 1 April 2003, by replacing the 8 times multiple applying to the highest price paid for firm entry capacity with a multiple of 1.1. The remaining elements of the overrun calculation would remain unchanged.

Respondents' views

There were 12 responses to this proposal, with the majority of respondents in support of the proposal.

Ticket to ride principle

The large majority of respondents, both for and against the proposal, supported the ticket to ride principle. Those supporting the proposal considered that the proposed lower multiplier would maintain the incentive on shippers to pre-book their capacity needs and there would remain a strong incentive not to overrun at constrained entry terminals.

Other respondents expressed concern that the lower multiplier might not be a sufficient incentive to guard against deliberate overrunning, which would undermine the market for entry capacity. Other points made were that the majority of overruns currently attract the 8 times multiplier and that reduced incentives to pre-book capacity might lead to Terminal Flow Advices (TFAs), which would affect the rights of those shippers which had pre-booked capacity.

Cost reflectivity versus penal charges

Respondents supporting the proposal considered that the current overrun charge was arbitrary and penal, particularly on non-constrained days, while it should be cost-reflective. Some respondents commented that the changes introduced in modification 500 had increased the penal nature of the charge.

A number of respondents opposed to the proposal also supported the principle that the overrun charge should be cost-reflective, but that it should be high enough to avoid deliberate overrunning.

Impact on markets

Respondents supporting the proposal argued that the current charge artificially raised shippers' risks and restricted trading in entry capacity. They argued that the proposal would reduce hoarding of entry capacity and stimulate secondary trading, resulting in a more efficient use of the transportation system. It was also argued that this would lower capacity prices and reduce Transco's constraint management costs.

Transco's views

Transco did not support this proposal. It considered that maintaining an appropriate incentive on shippers to pre-book capacity through the established commercial arrangements was a necessary pre-requisite to its efficient management of the pipeline system and considered that this could be impaired if the proportion of gas flowed against pre-booked capacity were to diminish.

Transco accepted that it was not plausible to pre-determine a uniquely appropriate level for the overrun multiplier, which would maintain an incentive on shippers to pre-book capacity, particularly on non-constrained days. Transco believed that incremental change was preferable to what it considered to be a significant change in this proposal.

Ofgem's views

Ofgem considers that the ticket to ride principle remains a fundamental aspect of the entry capacity regime. Without strong incentives on shippers to acquire capacity rights to cover their intended flows of gas onto Transco's NTS, there is a risk that the contractual basis underlying the entry capacity regime would be undermined. While the overrun charge may be subject to incremental change over time, for example, to reflect developments in

transportation arrangements, we consider that this particular proposal would significantly reduce the incentive on shippers to acquire capacity rights to cover their intended flows.

While we recognise the arguments made by some respondents that the proposal might stimulate the secondary trading of entry capacity and could result in a more efficient use of the transportation system, we do not consider that these potential benefits outweigh the risks associated with significantly reducing the incentives on shippers to pre-book capacity. In particular, Ofgem considers that the proposal would not better facilitate the efficient and economic operation of Transco's system, because reducing the incentives on shippers to acquire sufficient entry capacity rights could make it more difficult for Transco to efficiently manage entry capacity constraints.

In addition, the securing of effective competition between shippers may not be better facilitated if the entry capacity rights held by shippers are involuntarily affected through the issue of TFAs by Transco in the event of constraints caused by overrunning shippers.

As for electricity, there is no comparable system of overrun charges in the electricity wholesale trading arrangements, given that there is no system of capacity rights.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco not to implement this modification proposal because we do not consider that it would better facilitate the efficient discharge of Transco's obligations under its licence, as contained in amended standard condition 9 of Transco's GT licence.

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 Lyn Camilleri on 020 7901 7431.

Yours sincerely

Kyran Hanks
Director, Gas Trading Arrangements