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Dear Colleague,

Modification Proposal 0581 'Availability of Surrendered Entry Capacity'

British Gas Trading (BGT) raised modification proposal 0581, 'Availability of Surrendered Entry Capacity', in August 2002, requesting that it be granted urgent status. On 5 September 2002, Ofgem decided to reject the request for urgency and the proposal proceeded to consultation under the normal procedures of Transco's network code.

Ofgem has considered the issues raised in this modification proposal and has decided to direct Transco to not implement this proposal, because we believe that this proposal would not better facilitate the relevant objectives of Transco's network code.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

Transco has allocated short-term access rights to its National Transmission System (NTS) via six-monthly auctions of Monthly System Entry Capacity (MSEC) since September 1999. Following Ofgem's approval of modification 500, 'Long Term Capacity Allocation', Transco will make available long-term rights to access the NTS up to 15 years ahead of use. The first long-term auction is scheduled to commence on 15 January 2003.

Under Transco's Gas Transporter's (GT) licence,¹ Transco is required to make available for sale baseline levels of entry capacity and has incentives to make available additional capacity where that is demanded.

¹ Transco's price control for 2002-7 and incentive arrangements were included in Transco's Gas Transporter's licence in September 2002 via a direction made by the Authority. See '*Transco Price Control and NTS SO incentives 2002-2007 Licence modifications*', Ofgem, September 2002.

The costs of Transco's actions in managing entry capacity constraints and the revenues derived from non-obligated incremental entry capacity and sales of capacity made on the day are recovered from shippers through the network code capacity neutrality arrangements. Following Ofgem's acceptance of modification 0559, 'Changes to Buy Back Liabilities', from October 2002, capacity neutrality has applied to national end of day holdings of firm entry capacity. This end of day position reflects shippers' purchases of Quarterly System Entry Capacity (QSEC), MSEC and Daily System Entry Capacity (DSEC), net of any trades or sales of capacity back to Transco. Prior to this change, capacity neutrality applied to MSEC holdings only.

While not part of modification 0559, Transco has committed to use reasonable endeavours to accept zero-priced buy-back offers made prior to 17:00 hours on a gas day, thereby allowing shippers to reduce their end-of-day firm capacity holdings.

Ofgem released its decision on 20 December 2002 not to veto Transco's Pricing Consultation (PC) 76, 'NTS TO Entry Capacity Auction Reserve Prices and Exit Charges'. The effect of PC 76 is to set the reserve prices for MSEC at the same level as those applying in the long-term allocations for QSEC. In addition, from October 2003, the reserve prices applying for within day releases of entry capacity will be set at zero.

The proposal

Under the proposal, following the surrender of entry capacity to Transco for a zero price, Transco would be required to continue to assess whether any of this surrendered capacity can be re-offered to users. If in Transco's assessment, it were possible to release additional capacity later than 17:00 hours on the gas day, Transco would be required to make such capacity available to any user at zero cost. In the event of competing acceptances of capacity offered at any hour bar, the capacity would be allocated to each accepting user pro-rata in proportion to their acceptance.

Respondents' views

There were nine responses to this proposal. Four respondents offered qualified support for the proposal and five respondents opposed the proposal.

Release of capacity to the market

In justification for the proposal, BGT argued that it would ensure that there is no unnecessary withholding of available capacity from the market, which could impact upon the ability of Transco and users to efficiently balance the system. On the other hand, respondents opposed to the proposal argued that the risk of capacity being withheld was low. It was argued that most shippers had chosen not to utilise the zero-priced buyback mechanism, after taking into account a number of factors, including the risk that they would subsequently require the capacity, that there would be a capacity constraint or that they could trade the capacity for a positive price.

Efficient allocation of capacity

Those respondents opposed to the proposal considered that it would lead to an inefficient release of capacity at below its market value on certain days. It was argued that the pro-rating mechanism necessary to ration demand at a zero price would lead to inflated bids. These respondents considered that there was no reason to treat such capacity differently from other forms of capacity released in the short term and that the proposal would add unnecessary

complexity to the capacity regime. It was also argued that the proposal would slow the development of the secondary market.

Practicality

A number of respondents, including those which supported the proposal in principle, considered that it was not workable in practice. In particular, the zero price element was criticised and it was suggested that a zero reserve price could be used. In its response, BGT conceded that the price should be a zero reserve price and that revenues should flow to Transco via its incentives, as with other within-day sales.

Effect on Transco's incentives

Respondents were divided as to the impact of the proposal on Transco's incentives. It was argued that the proposal would expose Transco to the risk that it would have to re-purchase the capacity released for zero price later in the day, which would not be efficient. However, some respondents considered that Transco should not be able to earn incentive revenues on capacity that was re-released, because it would already have earned revenue on such capacity.

Transco's view

Transco did not support the proposal.

Release of capacity to the market

Transco considered that its recently established GT licence arrangements provide appropriate incentives for the management of entry capacity. In particular, in relation to the daily release of capacity, it considered that it should have regard to the risks and rewards specified in its buy-back incentive, as well as the wider considerations of the GT licence and the Gas Act.

Efficient allocation of capacity

Transco considered that the pro-rating element of the proposal would create an incentive on users to overstate their demand, which could result in an inefficient allocation and misleading signals. Transco considered that it would be inappropriate to operate different allocation mechanisms, which would operate in parallel with each other for the same type of capacity.

Practicality

Transco agreed with those respondents who considered that the proposal was impractical and noted that the preference expressed for a zero reserve price was consistent with PC76, under which, from October 2003, all DSEC sold on the day would have a zero reserve price.

Effect on Transco's incentives

Transco argued that the proposal was inconsistent with the requirements in its GT licence. It argued that the licence sets out its obligations in relation to releasing quantities of entry capacity and the revenue treatment of capacity sales. In particular, it stated that the licence specified that revenue from all within-day sales of capacity be treated under Transco's buy-back incentive. Transco argued that the premise of the proposal is that revenues that may arise from re-selling capacity previously bought back should be counted towards allowed revenue and therefore should be fixed at a zero price so that Transco does not receive allowed revenue twice. Transco argued that modification of its licence would be required in order to implement the proposal.

Transco also considered that it would be inappropriate to introduce changes to pricing arrangements through its network code, rather than through its pricing methodology.

Interaction with the electricity regime

Transco did not consider that the proposal would have any implications with respect to interactions between the gas and electricity regimes.

Ofgem's view

Release of capacity to the market

The primary justification for this proposal was to guard against Transco artificially withholding the level of capacity from the market. However, the arrangements established in Transco's GT licence require Transco to release close to the maximum physical quantities of capacity and also provide incentives on Transco to release capacity above these levels. We consider that these arrangements, together with Transco's other licence and statutory requirements, should be sufficient to guard against the artificial withholding of capacity, without requiring Transco to release additional capacity at a zero price.

Effect on Transco's incentives

Ofgem considers that Transco's incentive arrangements have been located in its GT licence in the interests of stability and to provide Transco with a sufficient degree of certainty. This certainty should allow Transco to efficiently respond to its incentive arrangements. Transco's buy-back incentive encourages it to release additional capacity in the short term, by allowing revenues from sales of non-obligated capacity to be netted off against the costs of buy backs. In addition, the revenue from all types of capacity made on the day of use of the capacity is netted off against buy-back costs. This allows Transco to trade off the benefits of releasing additional capacity within day, with the expected costs of managing an entry capacity constraint caused by the release of additional capacity.

The proposal could result in Transco being required to release additional capacity with no positive effects on its incentives and may expose it to increased risk, for example, where it is necessary for Transco to manage a capacity constraint which arises after it has been required to release additional capacity under the proposal. This proposal therefore conflicts with the arrangements established in Transco's GT licence and in this respect, Ofgem is not satisfied that the proposal would better facilitate the efficient operation of the NTS or the efficient discharge of Transco's obligations under its licence.

Efficient allocation of capacity

Releasing capacity for a zero price would introduce distortions into the capacity market on occasions when the market value of capacity is positive. It would create incentives on shippers to inflate their demand for such capacity, in order to secure capacity after it is scaled back. While BGT conceded that the relevant price at which the capacity is released under the proposal should be a zero reserve price, this does not amend the proposal.

Ofgem considers that the decision by a shipper to offer capacity back to Transco at a zero price is a commercial decision made by the particular shipper, after weighing up the costs and benefits of such an action. There are a number of different avenues available to shippers to

secure their capacity requirements, in the range of release mechanisms that Transco conducts and through the secondary market, without requiring Transco to release capacity in the manner detailed in this proposal. This proposal might also have the effect of hampering the development of the secondary market for entry capacity, by making capacity available at an artificial administered price. In this respect, Ofgem considers that this proposal does not better facilitate the securing of effective competition between relevant shippers and relevant suppliers.

Interaction with the electricity regime

Ofgem does not consider that this proposal would have any implications for the electricity regime.

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 relevant objectives of Transco's network code, as contained in Amended Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,



Lyn Camilleri
Senior Manager
New Gas Trading Arrangements