

OFGEM DECISION LETTER No. 0588

"Publication of further forward and option entry capacity information"
Version 1.0

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Shippers, Transco and Other Interested Parties

Dear Colleague,

Modification Proposal 0588, 'Publication of further forwards and options entry capacity information'

AEP Energy Services raised urgent modification proposal 0588 '*Publication of further forward and option entry capacity information*' on 20 September 2002.

Ofgem has considered the issues raised in this modification proposal and the responses received and has decided to accept the proposal because we believe that it will 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

Entry capacity regime

Transco has offered firm monthly system entry capacity (MSEC) rights to its National Transmission System (NTS) for sale via six-monthly auctions since September 1999. In addition to offering MSEC, Transco also releases firm and interruptible capacity on a daily basis where there is additional capacity available. MSEC auctions were held in August 2002 and cover a period from 1 October 2002 to 31 March 2003. The next round of MSEC auctions will be held between 12 and 25 February 2003 for the period 1 April to 30 September 2003.

Following Ofgem's approval of modification 0500, '*Long Term Capacity Allocation*', Transco also makes available long-term entry capacity rights to access the NTS up to 15 years ahead of use. The first long-term auction for the sale of quarterly entry capacity rights from 2004 to 2017 was held in January 2003.

Entry capacity buy-back

In the event of a constraint at an entry point (when physical capacity is less than capacity sold against which gas is flowing) Transco buys back the capacity it has sold until the constraint is relieved.

Under its Gas Transporter's licence, Transco has an incentive to efficiently manage the costs of buying back entry capacity it has sold but cannot make physically available. Under this incentive Transco has a £35 million target level of net buy-back costs and is rewarded for performance below target and penalised for performance above target. Transco's possible revenues and costs under this incentive are subject to a cap of £30 million and a collar of £12.5 million.

Transco's use of forwards and options for buying back entry capacity

In April 2002, Ofgem accepted modification proposal 0498 '*Capacity forward and option entry capacity management*', which gives Transco increased freedom to use a wider range of tools such as forwards and options contracts for the purposes of entry capacity management. The use of such tools is designed to allow Transco the opportunity to seek to minimise its exposure to buy-back costs.

In September 2002, Ofgem approved the form of Transco's Procurement Guidelines and System Management Principles Statement. These documents were prepared and published as part of Transco's obligations under Special Condition 27 of Transco's GT licence. Transco's Procurement Guidelines set out the kinds of system management services which it may be interested in purchasing in the period until the next statement is due and the mechanisms by which it envisages purchasing, entering into or otherwise acquiring them. Transco has an obligation to revise the statement during any such period if its intentions change during that period. The System Management Principles Statement sets out the principles and criteria by which Transco will determine, at different times and in different circumstances, which system management services it will use to assist it in the operation of the NTS and for what purpose. The System Management Principles Statement additionally sets out the principles and criteria under which Transco would resort to measures not involving the use of system management services in the operation of the NTS.

Tendering for forwards and options contracts

Transco has been tendering for entry capacity forwards and options contracts since April 2002.

The implementation of modification 0561 '*Publication of capacity forward and option costs*' on 15 August 2002 placed a requirement on Transco to publish certain information (weighted average price, volume contracted, volume offered, number of bidders and number of successful bidders) following each tender to sell back entry capacity to Transco through forward s and options contracts. However under this modification, Transco was not obliged to publish price, volume contracted or volume offered information where there had been fewer than 3 successful tenderers.

On 23 October 2003 accepted modification proposal 0587 '*Prospective publication of further forward and option entry capacity information*'. Under this modification Transco is required to publish specific information following the completion of each forward and option tender held. In relation to capacity forward tenders, Transco is required to publish information for each ASEP and for each day of the Forward Delivery Period tendered for. In relation to capacity option tenders, Transco is required to publish information for each ASEP and for each Option Exercise Period tendered for. Transco is also required to notify participants for each Gas Day (for each ASEP) of the volume of entry capacity options exercised on that Gas Day and the weighted average strike price of the options exercised on that Gas Day.

It should be noted that modification proposal 0587 was forward looking in nature and did not provide for the release of information relating to tenders that had been completed prior to the implementation date of the proposal.

The Proposal

This modification proposal provides for an amendment to the network code to require Transco to publish certain information within one day of the implementation of this modification, in relation to capacity forward and option tenders conducted prior to the implementation of this proposal.

In relation to capacity **forward** tenders, Transco would be required to publish the following information for each day of the Forward Delivery Period tendered for:

- the volume weighted average price of forward tender offers received;
- the volume of forward tender offers received;
- the minimum price of forward tender offers received;
- the maximum price of forward tender offers received;
- the volume weighted average price of forward tender offers accepted;
- the volume of forward tender offers accepted;
- the minimum price of forward tender offers accepted; and
- the maximum price of forward tender offers accepted.

In relation to capacity **option** tenders, Transco would be required to publish, for each ASEP and for each Option Exercise Period tendered for, the following information:

- the volume weighted average of option strike prices received;
- the volume of option tender offers received;
- the minimum of offered option strike prices;
- the maximum of offered option strike prices;
- the volume weighted average of accepted option strike prices;
- the volume of option tenders accepted;
- the minimum of accepted option strike prices; and
- the maximum of accepted option strike prices.

Under this proposal, Transco would also be required to notify users for each Gas Day (for each ASEP) between 1 April 2002 and the date of implementation of this modification, the volume of entry capacity options exercised on that Gas Day and the weighted average strike price of the options exercised on that Gas Day.

Respondents' views

Six responses were received in relation to this proposal and there was unanimous support for the publication of further capacity forward and option entry capacity information.

Increased liquidity / competition

The majority of respondents stated that increased transparency would lead to increased liquidity and would therefore lead to increased competition in the capacity buy-back market and ultimately lower costs for Transco's constraint management. One respondent stated that failure to provide the information contained within the proposal would weaken the competitive process

and lead to sustained premia and higher prices being paid by Transco to the detriment of customers.

Confidentiality

No respondents indicated that the publication of specific capacity forward and option costs information would breach confidentiality for participants involved in future tender processes. One respondent however noted that the information specified by the proposer would not specifically identify the party or parties that have been successful in the tender process. In this context the respondent indicated that it was important for the overall success of the process that commercial confidentiality is maintained.

One respondent commented that although there may be some identification of parties at ASEP tenders, where fewer participants were involved, this should not deter participation in the secondary market. The respondent also noted that, in any event, more information would be likely to increase competitive pricing amongst shippers. Another respondent indicated that confidentiality concerns are unlikely to be significant given that it is always open to shippers to decide whether or not to respond to tenders.

Monitoring Transco's performance in constraint management

A number of respondents considered that this proposal would enhance transparency and would allow participants to better assess Transco's performance as system operator. One respondent considered that a more open approach to information disclosure would balance the increased freedom that Transco now has to use a range of tools to manage the system.

Alignment with electricity market

One respondent welcomed this proposal because the release of further specific information in relation to constraint management tools aligned the gas and electricity markets.

Transco's views

Provision of information in relation to secondary market

Transco did not support implementation of this proposal. It did not consider that the prospective release of further information would further its relevant objectives under its GT licence. Transco therefore considered that it would be neither economic nor efficient to provide further information that could act as a guide for price setting by counter parties in a secondary market.

Transco's response further highlighted that it had efficiently managed its exposure in the buy-back market to date while publishing certain information only in relation to tenders where there were above three participants.

Transco's participation in secondary market

Transco argued that it is a participant in the secondary capacity market and is therefore in the same position as all other participants. Transco considered that this proposal seeks to impose unnecessary and inappropriate obligations on Transco that do not apply to any other participants in the secondary market. It considered that a request for further trading information could lead to pricing power for some participants, which would have a detrimental impact on the (efficient) operation of the system. Transco further considered itself to be a distressed buyer in

secondary markets and is concerned, as system operator, that the release of additional information might encourage price escalation in an illiquid market.

Confidentiality

Additionally, Transco argued that the release of forward and option trading information could expose confidential information about a participant's position, particularly if there were only one or two participants in a tender. Transco stated that implementation of the proposal might represent a breach of confidentiality and act as a deterrent to shippers taking part in future buy-back tenders.

Monitoring Transco's activities

Transco did not consider it appropriate for market players to be able to monitor its activities because the nature of the redistribution of benefits accruing to individual participants from the acceptance of forwards and options contracts means that there will not always be an alignment of individual and community interests.

Transco noted that its new incentives provide alignment between Transco and the interests of the community. Additionally Transco considered that its obligations to use a range of constraint management tools have been adopted in a philosophy of commercial discretion and therefore there is no requirement for the release of further information.

Comparison with storage market

Transco argued that in the storage market, the dominant storage operator is only required to publish information following a primary auction. There is no requirement in the storage market to publish data concerning bilateral trades.

Alignment with electricity market

Transco stated that there is no comparison between its constraint management tools and the electricity industry's physical management tools. It did not support respondents' views that this proposal would bring gas trading into alignment with the information disclosure level used in electricity trading.

Terminal Flow Advices

Transco stated that greater information disclosure may discourage participation in the forwards market for capacity leaving Transco with a greater dependence on the daily capacity buy-back mechanism which it considers is highly illiquid. Transco stated that if liquidity does not improve then reduced forwards participation may lead to a greater incidence in Terminal Flow Advices (TFAs).

Waiver of confidentiality rights

Following Ofgem's acceptance of modification proposal 0587, Ofgem indicated to Transco that it was minded to accept modification 0588 subject to all confidentiality issues being resolved with respect to price and quantity information submitted to Transco during capacity tenders since 1 April 2002.

In this context, Transco indicated that certain of the information to be disclosed under modification proposal may be the subject of confidentiality obligations and is unable to be disclosed by Transco. In order to enable it to release the information that is the subject of this

proposal, Transco subsequently wrote to a number of shippers seeking their consent to the release of price and quantity information submitted by those shippers that forms the subject of this proposal and, in addition, the waiver of any rights of confidentiality with respect to this information.

Transco has now obtained waivers of confidentiality rights from all but one shipper and is in a position to disclose the information that forms the subject of this proposal with the exception of the data pertaining to the individual shipper that has not responded. This shipper's information pertains to option tenders for a small volume of capacity at the Teesside terminal.

Ofgem's views

Ofgem considers that this proposal better facilitates the relevant objective in amended standard condition 9 of Transco's GT licence of securing effective competition between relevant shippers and relevant suppliers. This proposal should also assist Transco in managing constraints and minimising buy-back costs through its incentives. Ofgem therefore considers that this proposal will better facilitate the relevant objective of the efficient and economic operation of Transco's pipeline system.

As we stated in our decision letter for modification 0561 and repeated in our decision letter on modification proposal 0587, Ofgem continues to believe that the release of capacity and forward option information to the market will better facilitate competition between shippers in selling back capacity to Transco and as such, should assist in reducing buy-back costs and promoting liquidity in the secondary capacity market.

In particular, the more detailed post tender information to be published under this proposal, with no minimum threshold of successful tenders, should facilitate competitive entry into the buy-back market and the competitive re-pricing of entry capacity.

Ofgem does not accept the position as outlined by Transco regarding the degree of commercial discretion it should have with respect to the provision of information. As was outlined in our decision letter of 11 October on Transco's Procurement Guidelines, Ofgem considers that, as with NGC, there should be a greater expectation of transparency with respect to Transco's activities given its role as monopoly system operator. In Ofgem's view, the need for transparency is even more important given Transco's increased contracting freedoms and participation in forwards markets.

In this respect, Ofgem also considers that shippers and the wider industry and customers have a valid role to play in monitoring Transco's performance under its incentives, because it is customers who ultimately pay for the costs of Transco's system operation activities. As such, Ofgem considers that this proposal will bring increased transparency to Transco's system operation management and will better enable the industry as a whole to monitor Transco's performance and seek to reduce constraint management costs.

Confidentiality

Ofgem notes the concerns that Transco raised in the Final Modification Report that implementation of this proposal might represent a breach of confidentiality. Ofgem however considers that these concerns have now mostly been addressed through the confidentiality waiver letters obtained by Transco. Ofgem notes that one shipper has not yet signed a confidentiality waiver. With this in mind the legal drafting of the proposal has been prepared to

recognise that there is no obligation on Transco to release any confidential information pertaining to a particular user unless Transco has received a confidentiality waiver.

Alignment with electricity market

Ofgem also continues to believe that Transco should align its release of information in relation to trading with the requirements placed upon NGC in the electricity market wherever possible. Whilst NGC does not undertake tenders to buy back transmission capacity it nevertheless publishes information on the outcome of its tenders for balancing services via its web site. The details of this information provision are specified in its Procurement Guidelines and include price and volume information and the number of bidders and successful bidders.

Ofgem does not accept Transco's argument that its information provision requirements should not be compared with the electricity market. Transco argues that NGC can use physical tools in a monopoly procurement role to deal with constraints, whereas Transco uses financial tools within a secondary buy-back market involving other market players. Ofgem does not accept the distinction made by Transco and considers that both system operators have access to a range of tools that are procured in markets involving other participants. For example, as noted in our decision letter on modification proposal 0587, NGC purchases electricity on a forwards basis on competitive exchanges and publishes information regarding the results of its forwards tenders through its Procurement Guidelines.

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.

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,

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

Mark Feather
Head of Gas Trading Arrangements