

Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification proposal 0587 '*Prospective publication of further forward and option entry capacity information*'

AEP Energy Services raised urgent modification proposal 0587 '*Prospective 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

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. The most recent MSEC auctions were held in August 2002 and cover a period from 1 October 2002 to 31 March 2003.

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

SO Incentives – Modifications to Transco's GT licence

On 27 September 2002, Ofgem issued a direction under section 23 of the Gas Act 1986 to modify Transco's Gas Transporter (GT) licence to implement the SO incentives and the transmission asset owner (TO) price control from 1 April 2002. This direction followed two

statutory licence modification consultations on the Transco price control in April and August 2002 respectively.

The licence modifications include a number of day to day incentives on Transco to efficiently manage the operation of the NTS, including an incentive to efficiently manage the costs of buying back capacity it has sold but cannot make physically available.

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 capacity

On 9 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.

Tendering for forwards and options contracts

Transco has been tendering for entry capacity forwards and options contracts since April 2002. It has conducted four forwards tenders, seeking offers for buy-back forward contracts for May to September 2002.

Transco has also conducted six options tenders since April 2002, seeking offers for buy-back options to cover the summer and winter periods from 2002 – 2003.

After Transco's first forwards tender, Transco provided some information to the industry on the results of that tender. Transco published information stating that: only offers at St. Fergus had been accepted; offers had been received from 14 shippers; and Transco had accepted 29 offers from six shippers. However, Transco did not release information following subsequent tenders until the implementation of modification 0561 '*Publication of capacity forward and option costs*' on 15 August 2002. This modification 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 forwards and options contracts. However, under the modification, Transco is not required to publish price, volume contracted or volume offered information where there have been 3 or less successful tenderers.

The modification also provided that Transco is obliged to publish the volume and weighted average price of any capacity options exercised on that day. Similarly, however, Transco is not required to publish this information on a day where 3 or less options have been exercised.

In accepting the proposal, Ofgem indicated that it would provide valuable information to the market that should facilitate competition between shippers in selling back capacity to Transco which should, in turn, assist in reducing buy-back costs and promoting liquidity in the secondary capacity market. Ofgem stated that by revealing the information the proposal should facilitate competitive entry into the buy-back market and the competitive re-pricing of capacity.

Ofgem notes that AEP Energy Services has also raised urgent modification proposal 0588 '*Publication of further forward and option entry capacity information*'. Under this proposal Transco would be required to publish certain information in relation to capacity forwards and options tenders that it has undertaken prior to the implementation date of the proposal. For forwards tenders, information includes volume weighted average prices of offers received and accepted, maximum and minimum prices of forward tender offers received and accepted and volumes of forward tender offers received and accepted. This information would not be subject to any of the thresholds that currently apply.

For options tenders Transco would be required to publish the volume weighted average of option strike prices received and accepted, maximum and minimum option strike prices offered and accepted, and the volume of option tender offers received and accepted. Similarly, this information would not be subject to any of the thresholds that currently apply.

Under this proposal, Transco would also be required to notify participants for each Gas Day (for each ASEP) from 1 April 2001 to the date of the implementation of the proposed modification, the volume of entry capacity options exercised on that Gas Day and the weighted average strike price for the options exercised on that Gas Day.

Ofgem expects to issue its decision on this proposal shortly.

The proposal

This proposal provides for the network code to oblige Transco to publish specified information within one working day of the completion of each forward and option tender held, following implementation of this modification.

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

- 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, Ofgem would also be required to notify participants for each Gas Day (for each ASEP) of the volume and entry capacity options exercised on that Gas Day and the weighted average strike price of the options exercised on that Gas Day.

Respondents' views

Seven responses were received in relation to this proposal and there was unanimous support for the prospective publication of capacity forward and option costs.

Increased liquidity/ competition

The large majority of respondents stated that increased transparency would lead to increased liquidity and increased competition in secondary capacity and buy-back markets, ultimately lowering costs for Transco's constraint management. One respondent indicated that the publication of the information will encourage new entry and that shippers and traders will over time arbitrage and compete away any premia being charged at certain times or at certain terminals.

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.

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.

Alignment with electricity market

One respondent welcomed this proposal because the release of further specific information would align the gas and electricity market data release.

Transco's views

Transco does not support implementation of this proposal. It does not consider that the prospective release of further information will further its relevant objectives under its GT

licence. Transco therefore considers 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 what it considers to be an illiquid 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 considers that a key element of its success in this respect was the policy adopted for information disclosure. Therefore, Transco maintains that information should only be released where there are more than three successful tenders in respect of each tender, each ASEP and each time period.

Transco notes that its new incentives provide alignment between Transco and the interests of the community. Additionally Transco states that its new incentives have been established with an implicit understanding that Transco would be able to exercise increased levels of commercial discretion, including discretion over information release.

Transco argues that it is a participant in the secondary capacity market and is therefore in the same position as all other participants. Transco considers 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 considers 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 considers 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 thereby exacerbating its level of distress.

Additionally, Transco argues that the release of forward and option trading information could expose confidential information about a participant's position, particularly if there are only one or two participants in a tender. Transco suggests that if participants can identify if they are in a dominant position as seller, this could lead to exploitation of Transco's distressed position.

Furthermore, Transco does 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 argues 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.

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

Transco states 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 states that if liquidity does not improve then reduced forwards participation may lead to a greater incidence in Terminal Flow Advices (TFAs).

Ofgem's views

Ofgem considers that the release of the information outlined in this proposal should better facilitate 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. In this respect Ofgem also 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 15 August 2002 decision letter for modification 0561, 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 information to be published under this proposal, with no minimum threshold of successful tenderers, should facilitate competitive entry into the buy-back market and should facilitate the competitive re-pricing of 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.

Further, Ofgem does not accept Transco's argument that its information provision requirements should not be compared with the electricity market. Transco argues that NGC uses physical tools in its role as electricity system operator and procures these tools in a monopoly procurement role. Transco however states that it often uses financial tools, such as capacity forward contracts which are procured within a secondary buy-back market where it participates 'just like any other player'.

Ofgem does not accept the distinction suggested 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, NGC purchases electricity on a forwards basis on competitive exchanges and publishes information regarding the results of its forward tenders through its Procurement Guidelines.

In this respect we continue 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 would note that Transco has already incorporated provisions in its Procurement Guidelines that reflect the network code arrangements for the release of information relating to its entry capacity forwards and options tenders processes. In this respect we would expect Transco to update its Procurement Guidelines to reflect this decision.

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, as 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 of Transco's system operation management and will better enable the industry as a whole to monitor Transco's performance and to raise any concerns they may have with Ofgem as industry regulator.

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 'M Feather', written in a cursive style.

Mark Feather
Head of New Gas Trading Arrangements