

Direct Dial: 020-7901 7327

24 August 2001

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/0486

Dear Colleague,

**Modification Proposal 0486 'Wavier of notice period for Implementation of changes to transportation charges'**

Ofgem has carefully considered the issues raised in Modification Proposal 0486 '*Wavier of notice period for Implementation of changes to transportation charges*'. Ofgem has decided to direct Transco to implement this modification, because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

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

**Background to the proposal**

Transco conducted the first auctions for the sale of monthly system entry capacity (MSEC) to the National Transmission System (NTS) in September 1999. The monthly auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000). Further MSEC auctions were held in March 2000, August 2000 and February 2001. In addition to releasing MSEC, Transco also releases monthly interruptible system entry capacity (MISEC).

*Reserve prices*

Under the existing capacity regime Transco applies reserve prices to its sales of MSEC. These reserve prices were established following the implementation of Pricing Consultation 48, '*Methodology for Determining Floor Prices for Auctions of Monthly*

*System Entry Capacity*'. Pricing Consultation 48 provides for monthly reserve prices to be set at 75% of the long run marginal costs at each entry terminal.

#### *Revenue rebalancing mechanism*

Under its price control Transco is expected to earn around 5% of its target revenue from the sale of entry capacity. In the event that revenues from the MSEC auctions exceed (fall below) Transco's target revenue the over (under) recovery is addressed via a revenue rebalancing mechanism that was introduced through Pricing Consultation 60, *'Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS auctions'*. Under PC60, Transco addresses any under or over recovery within a dead-band of 10% through the 'K' adjustment factor. Any under or over recovery in excess of this dead-band is addressed through adjustments to NTS commodity charges subject to this charge being reduced to no lower than a minimum level. Any remaining over or under recovery is addressed through 'K'.

On 30 July 2001 Transco issued Pricing Consultation 65, *'Capacity Auction Revenue Redistribution Mechanism'*. This paper proposes an amendment to the existing auction over and under-recovery mechanism. The proposals provide for auction over-recoveries to be diverted into a fund that is to be used to offset the costs of entry capacity buy-backs undertaken by Transco during periods of system constraints. Transco has recently completed a consultation on this proposal. The proposal forms the subject of a separate decision letter that has been released today.

On 14 August 2001 Transco issued Pricing Consultation 66, *'Transportation charge adjustments following entry capacity auctions'*. This proposes an alternative revenue rebalancing mechanism where actual auction revenue is below target auction revenue. Under this proposal any shortfall of revenue implied by the forthcoming entry capacity auctions would lead to a general increase in transportation charges rather than an increase focussed solely on the NTS Commodity Charge. This proposal has recently been consulted upon and forms the subject of a separate decision letter that has been released today.

#### *Recent changes to the capacity regime*

On 29 June 2001 Transco issued an invitation to shippers to participate in the auction for the capacity period October 2001 to March 2002. This invitation included the amount of MSEC to be offered for sale in the auction.

Following the release of these quantities, shippers, Ofgem and customers raised a number of concerns regarding the volumes of capacity on offer. Transco's proposed MSEC volumes were significantly less than those quantities that were made available in the October 2000 to March 2001 auctions at certain terminals. In particular, a number of these shippers have indicated that the volumes of MSEC released by Transco are too low and do not reflect the physical capabilities of the NTS. Shippers have expressed concern that this will create an impression of scarce capacity and constraints and that this may lead to higher prices and a large over-recovery from the auctions.

To address these concerns a number of modifications were raised that proposed changes to the existing MSEC determination methodology. These were modification proposal 0477, '*Fifth Round Monthly System Entry Capacity Allocation*', modification proposal 0480, '*Fifth Round Monthly System Entry Capacity Allocation*', modification proposal 0481, '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*' and modification proposal 0483, '*MSEC Auction Quantity Revision and Capacity Incentive Adjustment*'.

Ofgem subsequently directed Transco to implement modification proposal 0481 whilst rejecting modification proposals 0477, 0480 and 0483. Modification proposal 0481 provided for the release of MSEC quantities for each Aggregate System Entry Point (ASEP) for each month equivalent to the highest of the monthly ASEP Maximum System Entry Capacities published by Transco in its auction invitation letter on 29 June 2001<sup>1</sup>. In reaching its decision, Ofgem indicated that modification proposal 0481 would better facilitate the efficient operation of Transco's NTS by ensuring that capacity allocated following the monthly auction better reflects the physical capabilities of the NTS. Since modification 0481 results in an increase in the volume of MSEC capacity made available in the auction, the current pricing methodology requires that reserve prices are reduced to take account of this increase in MSEC quantities, to meet Transco's auction target revenue.

Currently, there is a requirement under the Network Code for Transco to provide at least two months notice of any change in transportation charges including reserve prices. There is also a requirement for a one month period of notice with respect to changes to the commodity charge.

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<sup>1</sup> For a complete explanation of all the modification proposals and Ofgem's reasons for accepting modification 0481 please refer to Ofgem's letter of 9 August 2001, '*Ofgem decision – Winter 2001 Capacity Auction modifications*'

Following Ofgem's acceptance of modification 0482, '*Delay to system entry capacity auction for the period 1 October 2001 to 31 March 2002*' on 9 August 2001 the completion date for the MSEC auctions for the period 1 October 2001 to 31 March 2002 has been delayed from 31 August 2001 to 10 September 2001. The commencement date of the MSEC auctions is 29 August. The completion date of the MSEC auctions is 14 September 2001.

Since the MSEC auctions are scheduled to commence on 29 August 2001 a waiver of the standard two month notice period will be required if the revised reserve prices are to take effect.

Further, as the MSEC auctions will not be completed until 14 September 2001 there is less than one month before actual gas flows commence against acquired capacity holdings. Therefore, any adjustments to transportation charges following an over or under recovery against target revenue from the auctions can only be achieved from 1 October 2001 if the necessary notice period is waived.

### **The modification proposal**

The modification proposes that the Transitional document of the Network Code be amended to specify that the relevant notice periods be waived for the period from 15 August 2001 through to 25 September 2001 to allow Transco to implement adjusted ASEP reserve prices prior to the commencement of the August 2001 auctions. The modification would also enable Transco to implement any adjustment of transportation charges from 1 October 2001 following any revenue over or under recovery that may result from the auctions.

### **Respondents' views**

A clear majority of respondents were in favour of the modification. Most respondents supporting the proposal agreed that following Ofgem's acceptance of modifications 0481 and 0482, it will not be possible for Transco to provide the necessary notice period prior to any changes to transportation charges including reserve prices.

One respondent offered qualified support for the modification proposal. This respondent indicated that it did not support any waiver of the notice period with respect to a change in NTS commodity charges following an under-recovery in the event that PC66 is implemented.

This shipper outlined its opposition to PC66 and argued that the revenue adjustment mechanism should not be changed simply on the basis that there may be an under recovery.

This shipper also suggested that fluctuations in transportation charges are detrimental to the interests of suppliers and customers and make it difficult for suppliers to accurately forecast transportation costs and compete for new customers, thereby frustrating competition.

A number of respondents expressed concern regarding the timing of the proposal and its proximity to the commencement of the auctions. They warned that modifications that are raised so close to the auction commencement dates could increase market uncertainty leading to price volatility. One respondent went on to suggest that this uncertainty does not help shippers in developing bidding strategies, noting that this proposal should have been raised immediately after Ofgem's approval of urgent modification 0481. One respondent opposed to the modification raised concerns regarding the impact of 'short notice, highly significant modifications' which introduce volatility into transportation prices and make it difficult to quote to customers effectively.

Another respondent expressed disappointment that fundamental changes to the capacity regime have been introduced without a thorough review of associated impacts.

Some respondents questioned Transco's drafting of its legal text, suggesting that the drafting is not in line with the intent of the proposal. One respondent argued that the current legal drafting would allow Transco scope to adjust other transportation charges that may arise as a consequence of the auctions and that the text should be redrafted to waive the notice period for specific charges that have been identified.

The one respondent opposed to the modification argued that a one month notice period was inappropriate and suggested that a three month period for adjustments to transportation charges was more appropriate.

### **Transco's view**

Transco is in favour of the modification proposal. Transco argues that the proposal is necessary given Ofgem's acceptance of modification 0481, to allow it to adjust ASEP reserve prices to reflect the higher volumes of MSEC to be made available in the forthcoming winter auction. Whilst Transco acknowledges respondents' concerns regarding the timing of the proposal and the fact that tariffs for gas supply have already

been set, they note that possible price changes are considered an accepted element within the calculation of business risk.

Transco also states that it has amended the legal text in light of comments made by respondents to the initial modification proposal to clarify that the notice period will only be waived for transportation charges over the period of 15 August 2001 to 25 September 2001.

## **Ofgem's View**

Ofgem agrees with the concerns expressed by respondents that, as a principle, it is undesirable to reduce the notification period for adjustments to transportation charges to less than two months. However, Ofgem agrees with the majority of respondents that this modification is necessary to enable an adjustment to reserve prices following Ofgem's acceptance of modification 0481.

In addition, Ofgem believes that it is preferable to amend general transportation charges following any under or over recovery in the auctions from 1 October 2001. This would ensure that any transportation charging adjustments are effectively aligned with the capacity period of 1 October 2001 to 31 March 2002. Ofgem considers that any delay in adjusting transportation charges beyond 1 October 2001 may distort competition between shippers and suppliers as individual customer portfolios may differ and change across months. Consequently a delay in any adjustment could potentially advantage some shippers at the expense of others.

Ofgem accepts that shortening the notification periods with respect to changes to transportation charges may mean that customers will be required to complete contractual negotiations for the gas year commencing 1 October 2001 with an element of transportation charges undecided. Whilst this is undesirable Ofgem considers that it should not impede or hinder large customers in contracting for the forthcoming gas year. In particular, Ofgem would expect large consumers of gas to consider gas forward prices when contracting and form an expectation of any future movement in prices in formulating their contracts, irrespective of the outcome of the auctions. Therefore Ofgem does not believe that it is necessary for gas consumers to wait until transportation charges are publicly notified before striking contracts with their suppliers.

Ofgem accepts that Transco's revised legal drafting in its final modification report clarifies that the requisite notice period will be waived only for the period 15 August 2001 to 25 September 2001.

Ofgem believes that as the effect of implementing this modification will be to reduce the reserve prices at each ASEP, this will better facilitate the relevant objective of the economic and efficient operation of the pipeline system by reducing the possibility that reserve prices prevent capacity clearing at all terminals. Ofgem also believes that it will better facilitate the objective of facilitating competition between relevant shippers and suppliers by ensuring that any adjustment to transportation charges following the monthly auctions are effectively aligned with the October 2001 to March 2002 capacity period.

### **Ofgem's Decision**

Ofgem has therefore decided to consent to this modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Gas Transporter's 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,

Steve Smith  
**Director, Trading Arrangements**