

Direct Dial: 020-7932-5927

31 October 2000

BG Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/0401

Dear Colleague,

Modification Proposal 0401 'Reduction of Overrun Charges for System Entry Capacity'

Ofgem has considered the issues raised in Modification Proposal 0401 '*Reduction of Overrun Charges for System Entry Capacity*'. Ofgem has decided not to direct BG Transco to implement the modification, because we do not believe that this proposal will better facilitate the relevant objectives of BG 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

In September 1999, Transco conducted the first auctions for the sale of entry capacity to its National Transmission System ('NTS'). The auctions provided for the allocation of monthly system entry capacity to successful bidders for a total period of 6 months from 1 October 1999 to 31 March 2000. The second series of auctions was held in March 2000 for the six-month period of 1 April 2000 to 30 September 2000, and a third series was held in August 2000 for the six-month period of 1 October 2000 to 31 March 2001. In addition to holding monthly auctions, Transco makes additional entry firm and interruptible capacity available on a day-ahead basis and conducts day-ahead capacity buy-backs where necessary. A within-day capacity market became operational on 1 June 2000. From December 2000 onwards, Transco will also release a monthly interruptible capacity product.

A key element of the capacity regime is the overrun charge. The overrun charge is designed to encourage market participants to book entry capacity prior to nominating and flowing gas, thereby helping to ensure that entry rights are firm. In particular, overrun charges were originally set at levels that ensured that shippers would prefer to purchase capacity (either from Transco or from other shippers) rather than simply bring gas onto the system and face an overrun charge.

The overrun charges paid by shippers from 1 October 1999 to 30 September 2000 were set as the maximum of:

- ◆ 1.1 times the highest offer price accepted day-ahead in the daily entry capacity auction;
- ◆ 1.1 times the highest offer price accepted day-ahead in the buy-back market daily;

- ◆ 8 times the daily rate for monthly system entry capacity based on the weighted average price of the top 50% of bids, determined in the monthly auction;

or the lower of

- ◆ either 1.5 times the daily system average price (SAP) or 17.7p/therm.

In October 1999, Eastern (now TXU) raised Modification 0366 to reduce the high overrun charges on unconstrained days. Ofgem did not consent to this modification for a number of reasons, which included a concern that a two-tiered overrun regime would require system changes and create additional validation work for shippers.

During the following months, several shippers expressed concerns that the overrun charges in place from 1 October 1999 to 30 September 2000 were higher than needed to induce shippers to book sufficient capacity before flowing gas onto the NTS. It was believed that unnecessarily high overrun charges could inhibit secondary market trading, as shippers prefer to retain their capacity holdings in order to insure themselves against capacity overruns.

To address these concerns, on 20 May 2000, V-is-on raised Modification Proposal 401. Modification 401, which is fully described in the following section, proposed two sets of overrun charges to be applied to constrained and unconstrained days respectively. Under this proposal, overrun charges would be lower during unconstrained days in order to better reflect the cost to Transco of making capacity available to the market on those days. By contrast, the higher overrun charges for constrained capacity days would be designed to remain a significant deterrent to flowing gas without firm capacity rights when the system is experiencing difficulties. Ofgem did not grant urgency to this modification, because its acceptance within the existing capacity regime could have altered the value of the monthly capacity that had already been allocated during the March auctions for the six-month period from 1 April 2000 to 30 September 2000.

On 19 June 2000, in response to Modification Proposal 401, BG Transco raised Modification Proposal 408 "Review of Entry Overrun Charges". Under the original version of modification 408, different overrun charges applied at Aggregate System Entry Points (ASEPs) on constrained capacity days and unconstrained days. A constrained day was defined as one on which all interruptible capacity at a terminal had been interrupted and Transco had subsequently bought back firm capacity at that terminal during the day. It was proposed that on gas days when an ASEP is constrained, the overrun charge should be the greater of:

- ◆ 1.1 times the highest accepted bid price for entry capacity during the day;
- ◆ 1.1 times the highest accepted offer price for entry capacity during the day (the highest buy-back price);
- ◆ 8 times the daily rate for monthly system entry capacity based on the weighted average price of the top 50% of bids, determined in the monthly auctions;

and the lesser of

- ◆ either 1.5 times SAP for that day, or 0.6054 p/kWh.

By contrast, on unconstrained days, the overrun charge should be the greater of all the terms used in the calculation of the overrun charge for constrained days, except for the term "the lesser of either 1.5 times SAP for that day, or 0.6054 p/kWh", which was removed.

As a result of participants' comments and discussions, modification 408 was subsequently amended to remove the distinction between constrained and unconstrained capacity days, and to exclude the energy component of the overrun charges, i.e. the lesser of 1.5 times SAP or 0.6054p/kWh as originally formulated in modification 408.

The amended proposal was accepted by Ofgem and became effective on 1 October 2000. Under this modification, from 1 October 2000, shippers that flow gas without holding sufficient entry capacity are liable to pay the higher of:

- ◆ 1.1 times the highest accepted bid price for entry capacity during the day;
- ◆ 1.1 times the highest accepted offer price for entry capacity during the day (the highest buy-back price); and
- ◆ 8 times the daily rate for monthly system entry capacity based on the weighted average price of the top 50% of bids, determined in the monthly auctions.

As part of Modification 408, from 1 December 2000, the term "1.1 times the highest accepted bid price for entry capacity during the day" will be replaced with the following one:

- ◆ 1.1 times the weighted average, by volume, of the top 25% accepted bid prices for entry capacity on the day.

This new term will be introduced in order to minimise the likelihood of individual participants bidding up the overrun price on certain days. The delay in the introduction of this factor is attributable to system changes associated with its implementation.

The modification proposal

It is proposed that different overrun charges apply at ASEPs on constrained capacity days and unconstrained days. A constrained day is identified as one on which Transco curtailed or bought back firm capacity rights at the ASEP for all or part of the gas day.

On gas days when an ASEP is unconstrained, a user that delivers gas to the system in excess of the user's available system entry capacity at that ASEP shall pay an overrun charge equal to:

- ◆ 1.1 times the highest bid price that was accepted by BG Transco for daily capacity at the ASEP for the day; or
- ◆ 2 times the reserve price applicable to the ASEP in the monthly system entry capacity auctions, if no daily capacity has been sold.

On gas days when an ASEP is constrained, the overrun charges shall be the greater of:

- ◆ 6 times the daily rate for the monthly system entry capacity at the ASEP on the gas day;
- or the lesser of
- ◆ either 1.5 times SAP for that day, or 0.4p/kWh.

Respondents' views

All four respondents referred to their representations on Modification Proposal 408 '*Review of Entry Overrun Charges*'. Only one respondent expressed support for this proposal over Modification Proposal 408, on the basis that the former provided an absolute cap on overrun

charges, while the latter placed an unlimited liability on shippers. However, whilst supporting Modification 401, this respondent indicated that there should be no link between SAP and the overrun charge. The respondent also emphasised the need for a robust definition of “constrained capacity days” that takes account of Transco’s ability to alleviate a constraint at an ASEP by buying back capacity at a linked terminal.

The other respondents were concerned that the level of overrun charges proposed for unconstrained capacity days was too lenient and would have undermined the “ticket-to-ride” principle thus incentivising shippers to flow gas without holding sufficient entry capacity rights. Most respondents saw merit in the distinction between constrained and unconstrained-capacity days, with one shipper suggesting extending the definition of constrained-capacity days to include days when Transco buys back or curtails firm or interruptible capacity.

Ofgem’s View

Ofgem continues to believe that the rationale for the overrun regime should be to maintain the ‘ticket-to-ride’ principle by ensuring that it will never be cheaper to overrun a position than buy capacity and that the cost to the system of a participant overrunning is targeted back to the participant.

In our July 2000 document entitled *‘The New Gas Trading Arrangements: A review of the new arrangements and further development of the regime – A review and decision document’*, we illustrated that the existing overrun regime has been successful in reducing overrun volumes, with a reported year on year reduction of about 75%. In assessing Modification 408, we also recognised that capacity overrun charges could be higher than required to encourage adherence to the ‘ticket-to-ride’ principle and that the term linked to the energy price could be the factor leading to unnecessarily high overrun charges. Ofgem welcomed modification proposal 408 to remove the link to the daily energy price, as we agreed with concerns raised by shippers that the high level of overrun charges was potentially undermining shippers’ willingness to trade capacity and might be increasing the price of traded gas on constrained days.

In this context, Ofgem does not believe that modification proposal 401 better fulfils the objectives of the overrun regime and the relevant objectives of the network code for three reasons. First, it retains the energy component in the overrun charge structure. Second, the substitution, for unconstrained days, of the term “8 times the daily rate for monthly auctions” with “2 times the reserve price in the monthly auctions” may undermine the ticket to ride principle and may lower the incentive to purchase capacity before flowing gas. At this lower level, it would be more likely that on certain days, the overrun charge may be below the price of capacity in the secondary market. In general, this proposal may result in overrun charges for unconstrained days that are too low to fulfil the main objective of the overrun regime.

Lastly, this modification proposal incorporates a distinction between constrained and unconstrained capacity days, which Ofgem considers to be unnecessary and problematic. It is clear from recent experience that Transco has a number of measures it can use to mitigate capacity constraints in the short run including the use of linepack, the use of transportation interruption rights, the use of additional compression and buying back capacity at alternative terminals. In Ofgem’s view, it is not possible to produce a robust definition that will distinguish between constrained and unconstrained days. It is clear that capacity buy-backs at a particular terminal are indicative of capacity constraints on the network as a whole (although, not necessarily at that particular terminal). However, an absence of capacity buy-backs at a terminal does not mean that the system is not constrained. Given this, Ofgem does not believe that a two-tier overrun regime based on this distinction would provide shippers with appropriate incentives to maintain the ‘ticket to ride principle’. Ofgem continues to believe that the existing link to the within-day capacity market will ensure that overrun

charges vary during constrained and unconstrained days, removing the need for an explicit distinction between the two.

Ofgem's Decision

Taking all the above considerations into account, we have decided not to consent to this modification, as we believe that it does not better facilitate the relevant objectives outlined under Standard Condition 7 of the Public Gas Transporters' licenses. In particular, Ofgem believes that this proposal does not facilitate the achievement of an efficient and economic operation of Transco's pipeline system, because it may reduce the incentive to purchase capacity before flowing gas on certain days potentially leading to buy-back actions. Similarly, it does not facilitate competition between shippers to the extent that it may undermine existing firm rights by encouraging people to overrun.

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

Yours sincerely,

Mark Feather
Head of RGTA