Direct Dial: 020-7901 7327

24 January 2001

Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/0444

Dear Colleague,

Modification Proposal 0444 'Extend Capacity Period Sold To 12 Months in MSEC and MISEC Auctions for February 2001'

Ofgem has considered the issues raised in Modification Proposal 0444: 'Extend capacity period sold to 12 months in MSEC and MISEC auctions of February 2001'. Ofgem has decided not to direct Transco to implement the modification, because we do not 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

In September 1999 Transco conducted the first auctions for the sale of monthly firm entry capacity to the NTS (National Transmission System). The auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000). Further auctions for firm monthly entry capacity were held in March and August 2000 with entry capacity again sold for a period of six months in each auction.

It was originally envisaged that the third round of auctions, held in August 2000, would allocate entry capacity for a twelve month period (1 October 2000 to 31 September 2001). In particular, it was felt that after the initial two auctions of capacity, participants would have acquired sufficient familiarity with the auction process to enable auctions of capacity rights for 12 months.

However, prior to the commencement of the August 2000 auction round, Transco raised modification 0409, '*Review to monthly auction capacity parameters'*, which proposed limiting the sale of firm monthly entry capacity to six rather than twelve months. This proposal was supported by the majority of shippers, who felt it would allow them additional time to evaluate changes to the capacity regime, particularly in light of the results of the March 2000 auction round. Ofgem accepted modification 0409, with a view to introducing longer term auctions in subsequent entry capacity auctions.

In addition to conducting monthly system entry capacity auctions, Transco also conducts monthly interruptible system entry capacity auctions. The first of these auctions was held in November 2000 for a period of 4 months December 2000 to March 2001 following Ofgem's acceptance of Modification 410 *'Auctions of Monthly Interruptible System Entry Capacity'*. It was originally envisaged that this auction be conducted for the period October 2000 to March 2001, however the release of the MISEC product was delayed due to systems development problems experienced by Transco.

The modification proposal

The modification proposes that both monthly system entry capacity (MSEC) and monthly interruptible capacity (MISEC) should be auctioned on a twelve month profile rather than the current six-month profile. It also proposes that the MSEC auctions should be completed by 15 February 2001 and the MISEC auctions by 28 February 2001, with the capacity sold for the period 1 April 2001 to 31 March 2002.

Respondents' views

A clear majority of respondents did not support the modification. However, most of the respondents that opposed the modification nevertheless supported the principle of annual auctions. However they believed that the move to annual auctions should occur for the entry capacity period 1 October 2001 to 30 September 2002. This would align the period covered by the auction to the gas contracting year. In particular, the view was expressed that shippers would be required to acquire capacity for potential gas contracts that are yet to be negotiated. Some shippers indicated that any such uncertainty would be factored into auction prices.

Respondents highlighted a number of other reasons why the move to annual auctions should be delayed. Some noted that the lack of a reasonable period of time before the commencement of the 12 month auction would cause additional uncertainty. A number of participants argued that it was inappropriate to auction capacity for a period of 12 months until the results and implications of the Ofgem capacity investigation were known. Some participants indicated that if the proposal was implemented shippers would face the uncertainty of not having secured capacity rights and not knowing their capacity and commodity charges for the second half of the gas year October 2001 to September 2002.

Some shippers also argued that it was inappropriate to auction capacity for a 12 month period in advance of the gas storage year.

One shipper argued that it may be appropriate to the delay annual auctions until October 2001 as the outcome of the BPA process is currently not known. This shipper contended that without knowing the outcome of the BPA process Transco would not be utilising the most up to date information in framing monthly quantities.

Some respondents expressed opposition to annual auctions in principle indicating that gas flows cannot be predicted with certainty 12 months in advance. One respondent indicated that this uncertainty may contribute to increased demand for capacity and higher prices given the lack of a liquid secondary market and the penalties associated with overruns. This respondent also indicated that the introduction of NETA and further changes to the gas balancing regime may have significant impacts on the capacity regime also justifying a delay to any move towards annual auctions.

Most of the respondents supporting the proposal stated that longer-term auctions would reduce the uncertainty that has resulted from the six-month auctions and bring more stability to the capacity regime. One shipper indicated that a 12 month auction would enable shippers to invest time in developing the long term entry capacity regime. Another shipper indicated that the existing 6 month allocation period may be a contributory factor towards increasing gas prices.

Ofgem's View

In its July 2000 document '*The New Gas Trading Arrangements – A review of the new arrangements and further development of the regime – A review and decision document*' Ofgem indicated in reaching its decision on Modification 409 that it would prefer to see the introduction of longer term capacity rights for 12 or 18 months (leading up to the next price control period).

After consideration of respondents views Ofgem believes this issue is finely balanced.

Ofgem continues to prefer a move to longer term auctions. In particular, Ofgem considers that any move to longer term auctions would be consistent with Ofgem's objectives on improving long term investment incentives and price signals. However, Ofgem does recognise the concerns expressed by respondents that the introduction of a 12 month auction from 1 April 2001 would, at this particular time, create a degree of uncertainty for shippers participating in the auctions.

Ofgem's Decision

After careful consideration given the uncertainties raised by respondents associated with implementing an annual auction for the year 1 April 2001 to 30 March 2002, we believe that on balance there is not sufficient evidence to support the extension of the capacity period at this time. In particular, Ofgem believes there is insufficient evidence to suggest that an annual auction, at this point in time, would better facilitate the efficient and economic operation of the transmission system or the securing of effective competition between relevant shippers and suppliers.

Ofgem has therefore decided not to consent to this modification, as we do not believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Public 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