



Bringing choice and
value to customers

Transco, Shippers and Other Interested
Parties

Our Ref: Net/Cod/Mod/561
Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

15 August 2002

Dear Colleague,

Modification Proposal 0561 '*Publication of capacity forward and option costs*'

AEP Energy Services Ltd raised Modification Proposal 0561 '*Publication of capacity forward and option costs*' on 28 June 2002 and requested that it be granted urgent status. Ofgem granted the proposal urgent status on the same day and the proposal was issued for consultation.

Ofgem has considered the issues raised in this proposal and has decided to accept it because we believe that the proposal 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.

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. Transco has financial incentives to efficiently manage the costs of buying back capacity it has sold but cannot make physically available.

The next MSEC auctions are scheduled to occur in August 2002 and, following Ofgem's acceptance of modification proposal 0564, '*Amendment to period of Summer Capacity Auctions to Six months*', will cover a 6 month period from 1 October 2002 to 31 March 2003.

Transco's System Operator incentives

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 in December 2001.¹ On 12 April 2002, the Authority issued a notice ('the Original Notice') under section 23 of the Gas Act 1986 to modify the licence of Transco plc. The notice and licence modifications were accompanied by an explanatory document that was issued on the same day.²

The modifications concerned Transco's transmission asset owner price control for the period to 2007, its system operator incentives and its metering activities, all of which were covered in Part A of the notice. Part B of the notice related to the disclosure of Transco system operation information and the ability of third parties to raise modifications to Transco's Network Code.

In the light of the responses that were received to the 12 April consultation, Ofgem identified and logged a number of drafting changes to the proposed licence modifications as originally consulted on. Having considered the changes that were identified, Ofgem was satisfied that it had the power to direct that the modifications be made in their amended form.

However, during the consultation several respondents suggested that if the Authority decided to make changes to the proposed modifications, there should be a further consultation. In the light of these views the Authority decided on this occasion that it was appropriate to issue a second consultation. Since most changes are to Part A only, the Authority decided to restrict this second consultation to those licence modifications proposals contained in Part A only of the Original Notice. As such, the Authority decided not to reconsult on the proposed modifications contained in Part B. It is important to note that in deciding to reconsult on Part A only the Authority has not reached a decision in respect of Part B. No decision will be made until after the close of the second consultation.

Against this background, on 1 August 2002 the Authority issued a further section 23 notice in respect of Part A only of the proposed modifications to Transco's GT licence. The closing date for responses to this consultation is 30 August 2002.³

The views expressed in this letter do not in anyway fetter the discretion of the Authority with respect to the proposed licence modifications referred to above.

Under the licence modification proposals, Transco will be required to offer for sale baseline capacity volumes in the form of firm, tradable entry capacity rights through a series of long and shorter-term auctions. Transco will be able to earn incentive revenue from investing above its baseline capacity measures, in response to signals emerging from long-term

¹ *'Transco's National Transmission System Operator Incentives – Final proposals'*, Ofgem, December 2001.

² See *'Transco price control and NTS SO incentives 2002-7 Proposed licence modifications'*, Ofgem, April 2002; *Transco price control and NTS SO incentives 2002-7, 'Explanatory notes to accompany the section 23 notice of proposed licence modifications to Transco's gas transporter licence'*, Ofgem, April 2002.

³ See *'Transco's price control and NTS SO incentives 2002-07 Proposed licence modifications'*, Ofgem, August 2002; *'Transco price control and NTS SO incentives 2002-07- Log of changes to the proposed licence modifications'*, Ofgem, August 2002; and *'Transco Price Control and SO incentives 2002-7 – Proposed licence modifications'*, Ofgem letter, 1 August 2002.

auctions. The proposals also provide for a number of day to day incentives on Transco to efficiently manage the operation of the NTS.

Following Ofgem's acceptance of Modification Proposal 0540, '*Delay of Licence and Effects on Capacity Incentives*' on 28 March 2002, new parameters were introduced to Transco's buy-back incentive with effect from 1 April 2002 to 31 March 2003. Under this modification, Transco has incentives to efficiently manage the costs of buying back capacity it has sold but cannot make physically available. Transco may need to buy back capacity as a result of its maintenance programme, seasonal or plant reliability reasons. Transco faces 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

As part of its final proposals, Ofgem also indicated that Transco should be given greater commercial freedom and discretion under its new incentives. This includes the ability to contract forward for system management services including capacity and gas in circumstances where Transco believes this would be more efficient.

In this respect 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.

Ofgem has also proposed, as part of its statutory consultation under section 23 of the Gas Act, that Transco should publish Procurement Guidelines, a System Management Principles Statement and a System Management Services Adjustment Data (SMSAD) methodology statement as a consequence of its increased freedom to procure and utilise more flexible system management tools such as forwards and options contracts for both capacity and energy. Transco issued drafts of these statements for consultation on 19 June 2002. The consultation period on these statements ended on 10 July 2002 and Transco is currently considering the responses it has received. As part of this consultation process Ofgem also provided its preliminary thoughts on the draft statements in an open letter to Transco dated 5 July 2002.

In providing comments on Transco's initial draft of its Procurement Guidelines, Ofgem has indicated that the guidelines should provide information regarding the outcomes of the procurement processes that Transco undertakes for its system operation, including services such as capacity forward 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. From the third forwards tender, Transco changed the format of its tender to seek offers for a minimum of two days rather than entire months. It also restricted offers to the St Fergus terminal and restricted the offer prices to less than or equal to 0.045 p/kWh. In the fourth tender, Transco also sought offers for the Teesside terminal and specified a maximum price of 0.0065 p/kWh. Transco has conducted five options tenders since April 2002, seeking offers for buy-back options contracts for the same period.

Following Transco's first forwards tender, it provided some limited information to the industry on the results of the tender. It stated that only offers at St Fergus were accepted, offers were received from 14 shippers and Transco accepted 29 offers from six shippers. Transco also notified shippers that the results of the tender had no impact on the capacity overrun charge.

Information disclosure

As part of its published licence modifications for statutory consultation under section 23 of the Gas Act 1986 issued on 12 April 2002 (referred to above), Ofgem has also proposed licence amendments to require Transco to comply with Network Code obligations to release commercial and operational information relating to the operation of Transco's pipeline system. As explained above, Ofgem is not reconsulting on these proposed changes and expects to be in a position to determine whether or not to direct that the changes be made shortly following the completion of the 1 August consultation under section 23 of the Gas Act. Ofgem believes that the disclosure of information relation to the operation of the NTS should increase the efficiency of the wholesale market and help to address existing asymmetries in access to operational information that may be contributing to increased system balancing costs and volatility in wholesale prices.

The initial proposal

This proposal provides for the Network Code to be modified to oblige 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. Under the proposal Transco would also be obliged to publish daily the volume and weighted average price of any capacity options exercised on that day.

Respondents' views

The majority of respondents supported the proposal, with some respondents qualifying their support.

A number of respondents argued that information transparency is key to facilitating the development of an active and liquid secondary capacity market. They argued that information relating to Transco's use of capacity management tools is vital to enable shippers and customers to understand the dynamics of the market and to assist shippers in assessing the value of entry capacity. It was further argued that this will facilitate new entry and greater competition in the buy-back market. One respondent argued that accurate and timely reporting of Transco's actions will increase shipper confidence in Transco's actions, making it more likely that shippers will participate in such tenders. Another respondent stated that the publication of information relating to the tenders will assist shippers in making competitive offers to Transco in future tenders. A number of shippers indicated that the proposal would lead to reduced buy-back costs.

One respondent argued that increased information flows are more important as the industry moves towards a regime of long-term capacity auctions because of the increased risk of mispricing long-term positions.

Reference was made by two respondents to the concerns that Transco has expressed in recent workstream meetings, that providing information on its tenders would be detrimental to

the development of a secondary market for capacity. One of these respondents argued that provision of better information appeared to be the most obvious and simple way of encouraging liquidity into the buy-back market. Both respondents felt that Transco should not withhold such information unless there are issues of commercial confidentiality. However, one respondent argued that the commercial confidentiality requirements should not be applied in the same way as for competitive market players, because it is essential that shippers and customers, who bear the cost of Transco's actions, are able to monitor its actions.

Another respondent qualified its support for the underlying principle of the proposal because it felt that careful thought needs to be given to how, when, where and to whom the information is disseminated. It considered that it was important for the overall success of the tender process to maintain the commercial confidentiality of Transco and users.

A number of respondents felt that shippers and customers should have access to the information to allow them to effectively monitor Transco's actions. They argued that shippers and customers ultimately bear the costs of any Transco actions and need to be able to ensure that Transco, as a monopoly provider, is operating the system efficiently in choosing to access alternative system management tools. One respondent argued that Transco does not need to keep its position confidential in order to maintain its competitive advantage because the money it spends on system management belongs to shippers. It stated that Transco, in its draft procurement guidelines, has accepted that it should publish this data.

One respondent argued that the current non-availability of information is a significant gap in the market information available to shippers and gives Transco an unfair advantage when buying back capacity and buying options, because Transco has full access to market information. Another respondent added that withholding such key data would set a dangerous precedent in a regime where Transco has information about shippers' positions and upstream information and has strong incentives to meet procurement targets. This respondent felt that this will become even more important if the proposed merger between Transco and NGC takes place.

Two respondents thought that the proposal should go further in the type of information which Transco should make available. One respondent added the maximum and minimum prices paid and the weighted average price and volume acquired for each strike price after the exercise of options contracts. This respondent also believed that this information should be published retrospectively, covering Transco's actions since April, prior to the upcoming entry capacity auctions. It argued that this will assist shippers in developing their bidding strategies for long-term capacity, which should reduce the costs of acquiring capacity and optimise any post-acquisition trading. Another respondent argued that Transco should publish the number of days or part periods accepted by Transco.

One respondent, while supporting the proposal, expressed concern about the uncertainty of the position of capacity forward and option contracts in relation to the Financial Services Act, the exemptions made to it implemented for the OCM and Transco's contractual requirements. It argued that the development of liquidity would be constrained until Transco and Ofgem are able to provide more clarity.

One respondent did not support the proposal because it felt that the proposal lacked sufficient clarity regarding the level at which the data would be provided. While this respondent agreed that Transco should be obliged to publish data at an aggregate system-

wide level, it was concerned that published data at any greater degree of granularity could compromise confidentiality and therefore deter market entry. This respondent did not believe that any details on the exercise of options contracts should be published unless the contract is directly related to the overrun charge for that day and felt that further debate on this proposal was needed during the process of consulting on Transco's Procurement Guidelines and SMSAD documents.

Transco's view

Transco does not support implementation of this proposal.

Transco argues that it is operating under a system of incentives under which it shares both risk and reward with users and that when tendering for option and forward contracts, it is purchasing secondary capacity and thus acting in a similar manner to a shipper or trader. Transco argued that these parties do not have to publish any information. It gave the example of the storage market and argued that the dominant storage operator is only required to publish information following a primary auction and no data concerning any bilateral trades.

Transco is concerned that the publication of the proposed data could act as a guide for price setting by counter parties, which would not be economic or efficient. In this respect Transco suggests that liquid markets do not exist for entry capacity and that a lack of liquidity would provide a further signal to a limited number of counter parties to increase their prices.

Transco considers that the publication of daily statistics of options called could be counter-productive because it may be construed as providing a signal of the proximity of capacity constraints. Transco considers that the proposal may also increase the potential for gaming in the form of users increasing flows onto the system and increasing spot offer prices to take advantage of Transco's 'perceived distress' and higher buy-back costs would be a likely result. Transco is also concerned that users may be trying to gain access to information about Transco's activities at St Fergus, which they may use to create greater costs for capacity holders at other entry points.

Transco argued that there would be merit in considering a proposal that all users should be required to publish their opportunity costs, which Ofgem has suggested are relevant in determining the value of secondary capacity.

Transco is also concerned about releasing commercially confidential information and suggests that if this proposal is implemented, aggregated information should only be published for transactions involving a minimum of six parties.

Transco argued that this proposal would change the basis on which it has entered into forward and option contracts with users and may limit the extent to which users are willing to contract with it for capacity buy-backs.

On the issue of monitoring Transco's performance under its incentives, Transco stated that it provides details of all tenders to Ofgem and does not consider that users have a role to play in monitoring Transco's trading activities.

Transco suggested that it would be minded to raise a further modification proposal to return the status quo if this proposal is implemented and prices subsequently increase. It argues

that this debate would be better placed as part of the development of its Procurement Guidelines.

Transco states that no mechanism has been suggested by which the release of the information in question would change a shipper's underlying valuation of firm capacity. Transco states that the information may effect the valuation of those shippers who may seek entry capacity for the purpose of selling it back to Transco at a profit in which case Transco does not believe that such activities would add to the efficient operation of the pipeline system.

Revised modification proposal

In response to concerns raised regarding the release of commercially sensitive information, AEP Energy Services Ltd has agreed to revise its proposal such that Transco will not be required to publish weighted average price, volume contract or volume offered information following each tender in circumstances where there are 3 or less successful tenderers. Further, Transco will not be required to publish on a daily basis the volume and weighted average price of any capacity options exercised on the day where 3 or less options were exercised.

Ofgem's view

In general terms, Ofgem believes that this proposal will provide valuable information to the market that should facilitate competition between shippers in selling back capacity to Transco and as such, should also assist in reducing buy-back costs and promoting liquidity in the secondary capacity market. In particular, by revealing prevailing market information on price and volumes for particular periods, the proposal should facilitate competitive entry into the buy-back market and the competitive re-pricing of capacity.

As such 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. Further, in so far as the proposal facilitates competition it should also assist Transco in managing constraints and seeking to minimise buy-back costs through its incentives. In this respect the proposal should therefore better facilitate the relevant objective of the efficient and economic operation of Transco's pipeline system.

Ofgem would also note that, 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 website. 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 believes that Transco should publish similar types of information in relation to its capacity buy-back tenders. Whilst Ofgem considers that the release of this information should be provided for in Transco's proposed Procurement Guidelines, we believe that it is appropriate for this information to be published at least on an interim basis under Transco's Network Code. In the event that Ofgem's proposed modifications to Transco's GT licence are implemented, Ofgem would envisage that this information would be provided for in the proposed Transco Procurement Guidelines.

Ofgem recognises the concerns expressed by Transco and some respondents that the proposal, in its original form, may entail Transco releasing confidential information. In

particular, Ofgem is concerned that the release of information where there has only been one successful tenderer could result in Transco breaching confidentiality provisions under existing forward and options agreements. In this respect, Ofgem notes that AEP Energy Services Ltd has amended its proposal to include a threshold of successful tenderers before Transco is obliged to publish the outcomes of its forwards and options tenders. Ofgem is satisfied that this threshold is an appropriate means of addressing these concerns with respect to forwards and options contracts that Transco has already entered into.

However, in principle Ofgem considers that publication of such information when there are only a small number of successful tenderers (ie below the threshold in the revised proposal) may be desirable in order to facilitate competitive entry into the buy-back market and the competitive re-pricing of capacity. The release of such information however would be subject to the removal of confidentiality restrictions in existing Transco forwards and options contracts. Ofgem would encourage further discussion of this issue by the industry for future tenders Transco may conduct.

Ofgem also believes 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 believes this proposal will better enable shippers and customers to monitor Transco's performance.

Ofgem notes Transco's concerns that the publication of capacity forwards and options information could act as a guide to price setting by counter parties and produce price increases. However, as a matter of general principle, Ofgem does not believe that these concerns should be addressed by restricting the release of price and volume information from the market.

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 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,

Mark Feather
Head of New Gas Trading Arrangements