

**OFGEM DECISION LETTER No. 0564**  
"Amendment to period of Summer Capacity Auctions to Six Months"  
Version 1.0

Direct Dial: 020-7901 7437

19 July 2002

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/0564

Dear Colleague,

**Modification Proposal 0564 'Amendment to period of Summer Capacity Auctions to Six Months'**

Shell Gas Direct raised Modification Proposal 0564 *'Amendment to period of Summer Capacity Auctions to Six Months'* and requested that it be granted urgent status. Ofgem granted the proposal urgent status on 5 July 2002 and the proposal was issued for consultation on the same day.

Ofgem has carefully 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**

In September 1999, Transco conducted the first auctions for the sale of firm, Monthly System Entry Capacity (MSEC) to the National Transmission System (NTS). The auctions provided for the allocation of MSEC to successful bidders for a period of six months (October 1999 to March 2000). Further auctions for MSEC were held in March 2000, August 2000, February 2001, September 2001 and February 2002. On each occasion entry capacity was sold for a period of six months.

The provisions of the Network Code originally envisaged that the MSEC auctions held in August 2000 would allocate entry capacity for a twelve-month period from 1 October 2000 to 31 September 2001. However, the capacity period was subsequently shortened to six months following Ofgem's acceptance of modification proposal 0409, *'Review to monthly auction capacity parameters'*. In addition, in respect of the February 2001 auction Transco proposed a move to a twelve-month capacity release period through modification proposal 0444, *'Extend Capacity Period Sold to 12 months in MSEC and MISEC auctions for February 2001'*. Ofgem however rejected this proposal. In rejecting this proposal Ofgem recognised a number of concerns expressed by respondents regarding uncertainties created by the short period of time available before the commencement of the auctions.

Ofgem has frequently expressed its preference for a move to longer-term auctions in order to provide shippers with a higher degree of stability and certainty regarding the structure of the entry capacity regime. However, all MSEC auctions to date have allocated capacity for a 6-month period only, with moves to 12 month auctions being rejected for a different reasons including aligning the auction year with the gas year, and providing industry participants with time in which to evaluate developments to the regime.

The existing provisions of the Network Code provide for the next MSEC auctions to be completed by 31 August and provide for an allocation of 12 months of capacity (October 2002 to September 2003).

Transco recently raised modification proposal 0549, '*Summer 2002 Capacity Auction*'. In addition to proposing changes to the volumes of capacity offered in the forthcoming auctions as well as changes to the structure of the auction, Transco also consulted upon the period over which capacity should be allocated and sought views on whether this should be extended from 12 months to 24 months. Transco did not consult on the option of reducing the allocation period to 6 months. The majority of respondents to the consultation supported a 12 month auction although some expressed a preference for a 6 month auction citing a number of reasons including uncertainties surrounding the auction over-recovery distribution mechanism, and the treatment of buy-back costs. In response to the views expressed by respondents, Transco retained the 12 month allocation period and, as such, Ofgem was not required to decide on the issue as part of the modification proposal.

Shell Gas Direct has subsequently raised this modification proposal.

#### *Transco System Operator incentives proposals*

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 in December 2001 '*Transco's National Transmission System Operator Incentives – Final proposals*', Ofgem, December 2001. and published licence modifications for statutory consultation under section 23 of the Gas Act 1986 together with an explanatory note on 12 April 2002. '*Transco price control and NTS SO incentives 2002-7 Proposed licence modifications*', Ofgem, April 2002. These proposed modifications seek to introduce into Transco's Gas Transporter (GT) licence, with effect from 1 April 2002, new price controls and system operator (SO) incentives for Transco. Ofgem is currently considering the responses that it has received to this consultation. 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 these 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 auctions. The licence modification proposals also provide for a number of day-to-day system operation incentives on Transco.

#### **The proposal**

The proposal provides for two separate six-month allocations of entry capacity for the gas year 2002/3 (October to September) to be held. An auction for capacity for the period October 2002 to March 2003 would be held in summer 2002 and a second auction for capacity for the period April 2003 to September 2003 would be held in February 2003. The proposal envisages that longer-term auctions would cover annual or longer periods commensurate with the gas year.

#### **Respondents' views**

A clear majority of the respondents were in support of the proposal.

Respondents supporting the proposal expressed concern about uncertainties relating to the regulatory regime. These uncertainties included the outcome of proposals to amend Transco's Gas Transporter's licence, as well as uncertainties regarding the treatment of buy-back costs, auction over recoveries and the preparation of a number of the supplementary statements referred to in the proposed amendments to Transco's licence including the Procurement Guidelines and System Management Principles Statement.

Some respondents commented that taking into account the uncertainties and the minimal period of time prior to the auctions a 6-month capacity period was appropriate.

One respondent argued that recently raised modification proposals, if implemented, would also impact on the capacity regime during the 12-month period of allocation.

One respondent thought that the modification would ensure that further changes to the entry capacity regime can be accommodated while impacting only a shorter period of capacity. This respondent felt that limiting the forthcoming auctions to six months will allow shippers to build their understanding of the final drafting of Transco's proposed licence modifications and its supplementary documents into their future auction strategies.

Another respondent felt that it would be prudent to limit change to a minimum and continue the six-monthly allocations, in order to enable the industry to concentrate on the prerequisites it considered necessary for the long-term entry capacity arrangements. These prerequisites included the completion of Transco's licence conditions and its supplementary statements, an understanding of the interaction between capacity neutrality and the licence conditions, an understanding of revenue flows under Transco's incentives, the impact of the incentives on transportation charges, and the existence of effective systems interfaces between Transco and users.

While supporting the proposal, one respondent felt that implementation of this proposal would not guarantee certainty because new modification proposals could be raised. It stated that if the uncertainties caused by recent and potential future modifications were removed such that shippers had sufficient time to consider their impact prior to the start of the auctions, then it would support a 12-month auction in line with the gas year.

One respondent stated a 6-month allocation will limit the exposures of participants in the face of uncertainty and would have a further benefit in that better information on Transco's maintenance programme for summer 2003 would be available.

Another respondent stated that it operated on a short-term basis, with its capacity requirements often changing on a month-by-month basis in response to market conditions.

While one respondent preferred a 12-month auction, it stated that it would support this proposal if a majority of shippers supported a 6-month auction.

One respondent did not support the proposal. While this respondent recognised that there remains some uncertainty regarding the entry capacity regime, particularly relating to the distribution of over or under-recoveries, it considered that these uncertainties contribute a much less material impediment to a twelve-month auction compared with the past. In particular, its view is that the release of quantities of entry capacity at close to unconstrained levels on a year round basis rendered the remaining uncertainties less significant.

### **Transco's view**

Transco recognises respondents' concerns about uncertainty surrounding the future of the entry capacity regime, particularly that shippers may not wish to make long-term commitments until the proposed amendments to Transco's GT licence have been implemented.

However, Transco expressed a concern that, if the proposed modifications to Transco's licence were made, it would be subject to a reasonable endeavours obligation to offer for sale all long-term baseline capacity for this formula period before 1 October 2002. It therefore is concerned that this proposal would not better facilitate the relevant objective in Standard Condition 9(1)(b) of its GT licence, the efficient discharge of its licence obligations, if Ofgem's proposed changes are implemented. It stated that, apart from this concern, it was neutral to the proposal.

### **Ofgem's view**

Ofgem recognises the strong preference of respondents to this proposal to continue with a six-monthly allocation of entry capacity for the forthcoming auctions.

Ofgem continues to prefer a move to longer-term auctions of entry capacity. However, Ofgem does recognise that the introduction of a 12-month auction at this point in time would be inappropriate because of the concerns expressed by respondents regarding the uncertainties in the capacity regime and the impact of these uncertainties on shippers preparing bidding strategies for the auctions.

Ofgem notes Transco's concern that this proposal would not better facilitate the relevant objective in its GT licence of the efficient discharge of its licence obligations, if Ofgem's proposed changes are implemented. However we would note that any decision placed before the Authority under amended standard condition 9 (Network Code) of Transco's GT licence has to be assessed against the criteria set out therein having regard to the Gas Act 1986, the Authority's duties, the licensee's duties and all relevant facts. In essence, in respect of this modification proposal, this means that it has to be assessed against the background of the licence and the Network Code as they exist today – not as they may be in the future as a result of a proposed licence modification.

As noted above, Ofgem is currently considering the responses it has received to the section 23 consultation issued on 12 April 2002. As such, no assumptions can be made about the outcome of this consultation process. Accordingly therefore Transco's concerns regarding its future licence obligations are not relevant to Ofgem's decision on this proposal which, as we have indicated, has been assessed against the background of the licence and Network Code as they exist today.

### **Ofgem's decision**

Ofgem has carefully considered the issues raised by this modification proposal in relation to the forthcoming auction of entry capacity. Given the views expressed by respondents that they consider the level of uncertainty too high to enable them to effectively value capacity over a 12 month period, Ofgem considers that a six month auction of entry capacity better facilitates the securing of effective competition between relevant shippers and relevant suppliers.

Accordingly, Ofgem has decided to direct Transco to implement this modification, as we consider that it would better facilitate the relevant objectives as outlined in Amended 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***