Shippers, Transco and other Interested Parties

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Dear Colleague,

Modification Proposal 0653 'Revision to entry capacity overrun charges'

ConocoPhillips raised modification proposal 0653 *'Revision to entry capacity overrun charges'* on 2 October 2003.

Ofgem has carefully considered the issues raised in this proposal and has decided to direct Transco not to implement this proposal because we consider that it does not better facilitate the relevant objectives of Transco's network code, as set out under standard condition 9 of Transco's Gas Transporter (GT) licence.

In making this decision Ofgem has taken into account Transco's obligations under its GT licence, our wider statutory duties and all relevant facts. We have set out below the reasons for our decision to direct Transco not to implement modification proposal 0653.

Background to the proposal

When the new gas trading arrangements were introduced in 1999, one of the fundamental elements of the regime was the 'ticket to ride' principle. This principle is that shippers should acquire entry capacity rights to cover their flows of gas onto Transco's National Transmission System (NTS) and that there should be no incentive for a shipper to flow gas in excess of its entry capacity rights ('overrunning'). At that time[1], we did not consider that there should be separate overrun charge regimes depending on whether or not the terminal is constrained.
The overrun charge was set at the highest of:

[1] *'The New Gas Trading Arrangements: A decision document'*, Ofgem, September 1999.

- 1.1 * the highest bid price accepted at D-1 in the daily entry capacity auction;
- 1.1 * the highest offer price accepted at D-1 in the buy-back market daily;
- 8 * the daily rate for Monthly System Entry Capacity (MSEC); and
- 1.5 * the System Average Price (SAP) for gas.

Since the introduction of overrun charges, there has been continuing debate about whether the charge is too high. Following implementation of modification 0408, *'Review of Entry Overrun Charges'* in July 2000, the energy component of the overrun charge was removed and the overrun charge was amended to be set at the highest of:

- 1.1 * the weighted average price (WAP) by volume of the top 25% of accepted bids for daily capacity;
- 1.1 * the highest accepted offer price at D-1 in the buy-back market; and
- 8 * the daily rate for MSEC (based on the WAP of the top 50% of accepted bids).

In accepting the proposal, Ofgem reiterated its support for the ticket to ride principle and also stated that consistent overrunning could be in breach of the Gas Shippers' licence. In particular, we stated that there was a strong rationale for having terms linked to the prices paid during the primary capacity release and that it should never be cheaper to overrun than to buy capacity.

In November 2001, Ofgem published the results of its investigation into shipper conduct in the capacity market in October 2000. One aspect of the investigation was whether any shippers had been consistently overrunning. While we did not find any evidence of deliberate overrunning, we again confirmed our support for the ticket to ride principle and stated that overrun charges are designed to provide shippers with strong commercial incentives to purchase capacity before flowing gas and ensure that the costs to the system of a participant overrunning are targeted back to that shipper.

Following Ofgem's approval of modification 0500, *'Long Term Capacity Allocation'*, Transco makes available the system operator (SO) output measures through auctions of quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use.

As part of modification 0500, the overrun charge was amended to the highest of:

- 8 * the highest accepted bid price for firm entry capacity in any of the forms of allocations Transco holds;
- 1.1 * the WAP by volume of the top 25% of accepted capacity surrender offers;
- 1.1 * the WAP by volume of the top 25% of accepted capacity forward contracts; and
- 1.1 * the WAP by volume of the top 25% of exercised capacity option contracts.

In accepting modification 0500, Ofgem supported reflecting Transco's increased use of capacity management tools such as forward and options contracts in the overrun charge, but considered that the method by which overrun charges are derived should ultimately be set out in the System Management Services Adjustment Data methodology described in special condition 27 of Transco's GT licence.

In September 2002, AEP raised modification proposal 0589 *'Revision to entry capacity overrun charges ahead of next auctions'*. This modification proposal proposed amending the entry capacity overrun charges, by replacing the 8 times multiple applying to the highest price paid for firm entry capacity with a multiple of 1.1. Ofgem directed Transco not to implement this modification proposal. In rejecting the proposal Ofgem outlined its concerns that it would reduce incentives on shippers to acquire sufficient capacity rights.

The proposal

This modification proposal would amend the entry capacity overrun charges, so that the highest price from each of the firm capacity auctions[2] would be averaged and then multiplied by a factor of eight, in order to "smooth" out the effect of any erroneous bids accepted in any of the firm capacity auctions.

Respondents' views

There were eight responses to this modification proposal. The majority of respondents supported the proposal, although, among respondents supporting the proposal, some expressed qualified support.

Most respondents in favour of the proposal argued that shippers might be hit by excessively penal overrun charges when an erroneous bid has been accepted. One respondent stated that it was important to ensure the overrun penalty is not distorted by errors in shippers' bidding.

One respondent expressed disappointment at Transco's lack of support of the proposal. The same respondent noted that, although, as pointed out by Transco, there has been an increase in overruns since the implementation of modification 0500, at the same time there has been an increase in aggregate gas flows. The respondent also stated that if Transco finds consistent overrunning, the shippers involved should be identified to Ofgem. It also considered that instances of consistent overruns are most likely to occur as a result of the after-the-day allocation process or an oversight on the day. The respondent added that the entry capacity market is more liquid than one year ago, thus providing no incentives on shippers to intentionally overrun at any terminal.

According to the respondent, given that capacity can be secured at a zero reserve price within the day, any arbitrary multiplier can be selected in order to provide shippers with incentives to purchase sufficient entry capacity without being excessively penal. Another point raised by the respondent was that on days of system constraints, the existence of a penal overrun charging methodology may influence the cost of entry capacity on the secondary market, leading to exceptionally high prices for capacity.

Another respondent stated that Transco's concern that the implementation of this modification proposal could lead to a reduction in overrun charges is not enough to retain a flawed methodology. It also noted that, unless there is a large number of erroneous bids, there would not be a reduction of charges in the majority of circumstances.

Some respondents supporting the proposal argued that there might be some merit in considering volume weighting for the different auctions, especially taking into account lower reserve prices for daily system entry capacity (DSEC), and to reflect the amount of capacity purchased in each type of auction.

One respondent who offered qualified support to this proposal stated that the proposal would

[2] Firm auctions incorporate long-term auctions, short-term auctions, rolling monthly auctions and daily auctions

reduce price spikes in charges to shippers. The respondent indicated that volatile system entry charges associated with the current regime could increase the costs of capacity management to Transco. However, it expressed concern that lower charges may lead to disincentives on shippers to pre-book entry capacity. For this reason, it suggested that only option (a) in the network code clause 2.12.3 (regarding the highest accepted bid price in any of the forms of allocations Transco holds) is amended, without modifying the other options relating to overrun charges regarding average accepted offer price, average accepted forward price and the average accepted exercise price.

Another respondent offered qualified support for the modification proposal because, despite agreeing that amending the overrun component from marginal to average price will smooth out the effect of erroneous bids, it expressed concern that it may be difficult to maintain adequate incentives for shippers to buy entry capacity.

Shippers who were against the modification proposal expressed their concern that its implementation may create disincentives for shippers to book sufficient entry capacity and to trade in the secondary market.

One respondent expressed its concern that this modification proposal does not follow the principles of modification 0500, which it said emphasised marginal pricing in overrun charges and that an average pricing methodology does not benefit the regime.

Another respondent who did not support the proposal stated that it would offer support for a change that specifically addresses the case of erroneous bids, but it also added that it should not become part of the general mechanism for determining the overrun charge.

One respondent suggested that the overrun charge should be established at a level where it provides an incentive to shippers to book capacity in advance and where it reflects the costs incurred as a result of the overrun. The respondent stated that the proposal did not meet these objectives.

Transco's views

Transco did not offer support for this proposal. It did not consider that amending the entry capacity overrun charge arrangements as outlined in the modification proposal would better facilitate the relevant objectives of its network code. In particular, Transco expressed its concern that the proposed change may reduce the effectiveness of the overrun charging methodology by leading to a disincentive on shippers to pre-book entry capacity. Transco stated that this could impede the efficient and economic operation of the pipeline system by impeding Transco's ability to manage flows at entry via its capacity management tools. It also stated that the proposal could lead to an increase in the likelihood of entry gas flows exceeding the aggregate capacity holdings, thus possibly resulting in an increase in the use of terminal flow advices (TFA) at affected entry points.

Transco commented that the acceptance of a high priced bid could have resulted from an offer that reflected shippers' value of capacity or as a result of an error. Transco stated that only the manifest error example provides a case for averaging. In this context, Transco commented that it has been difficult in the past to introduce a system that could identify erroneous bids. It noted that the current form of the modification proposal would remove the effect of erroneous bids, but at the same time it would cause a reduction in overrun charges.

As regards the levels of transportation charges after the introduction of modification 0500, Transco argued that the annual increase in overrun quantities has been five-fold, and has not been matched by the increase in the aggregate flow quantities into the system (which have increased by six percent).

Transco agreed with respondents supporting the use of some form of weighting in the calculation of overrun charges, especially considering that the majority of entry capacity is sold on a long-run basis. Transco stated that a balance should be drawn between ensuring a correct weighting and avoiding system complexity. It also expressed its willingness to undertake further analysis on recent overrun trends and to facilitate discussion on these issues at future industry meetings.

Ofgem's views

Ofgem recognises that a number of respondents considered that amending the entry capacity overrun charges, as outlined in the modification proposal, would smooth the level of charges thereby reducing the impact of an erroneous high priced bid for entry capacity.

Whilst we acknowledge the effects of erroneous bids on overrun charges, Ofgem is not, however, convinced that it is appropriate to adjust the methodology for deriving these charges in the manner proposed. As we stated in our decision on modification proposal 0589, Ofgem considers that the ticket to ride principle remains a fundamental aspect of the entry capacity regime. Without strong incentives on shippers to acquire entry capacity rights to cover their intended flows of gas onto Transco's NTS, there is a risk that the contractual basis underlying the entry capacity regime could be undermined. Ofgem considers that this particular proposal may reduce the incentive on shippers to acquire capacity rights to cover their intended flows and could increase the risk of shippers under-booking capacity.

In this respect, whilst we agree that it is not desirable for erroneous bids to be reflected in overrun charges, we are nevertheless concerned that this proposal would also reduce the extent to which genuinely high priced bids for capacity are reflected in these charges.

Ofgem considers that it may be more appropriate to address the problem of potentially high exposure to overrun charges by developing procedures to mitigate erroneous bids (e.g. manifest error provisions).

Ofgem agrees with those respondents who noted that the proposed modification does not take into account the different volumes that emerge in different types of auctions. Ofgem considers that, to a great extent, a weighted average price of capacity from each of the firm entry capacity auctions would be more reflective of the prices and volumes of capacity bid in the longer- term auctions, for example.

Ofgem has noted that there has been a considerable increase in overrun volumes in the past year (2002 -2003). It is unclear to Ofgem that the parameters of this proposal would allow Transco and shippers to adequately address this problem.

On this basis, Ofgem considers that the proposal would not better facilitate the efficient and economic operation of Transco's system, because reducing the incentives on shippers to acquire sufficient entry capacity rights ahead of the gas day could make it more difficult for Transco to efficiently manage entry capacity constraints.

Ofgem considers that rather than seeking to mitigate the effects of manifest errors on overrun charges, it would be more appropriate to develop manifest error provisions that seek to directly address such errors closer to the time at which they are made. It is noted in this respect that in its decision on modification proposal 0419 *'Avoidance or correction of shippers errors in purchasing and selling entry capacity'* Ofgem suggested that industry participants could develop an appropriate set of manifest error provisions. To this point however, no such provisions have been developed.

Ofgem's decision

Ofgem has carefully considered the issues raised by this modification proposal. For the reasons outlined above, Ofgem has directed Transco not to implement this modification because we do not consider that it would better facilitate the achievement of the relevant objectives as set out in amended standard condition 9 of Transco's GT licence.

If you require any further information in relation to this modification please feel free to contact me on the above number or Tolani Azeez/Matteo Guarnerio on telephone 0207 901 7043/7493.

Yours sincerely

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Director, Gas Trading Arrangements