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20 December 2002

Dear Colleague,

Pricing Consultation Paper PC 76 - NTS TO Entry Capacity Auction Reserve Prices and Exit Charges

Transco raised Pricing Consultation (PC) 76, '*NTS TO Commodity Charge*', for consultation on 1 November 2002 and submitted its report to Ofgem on 12 December 2002. Ofgem has decided to not veto this proposal because we consider that the proposal better facilitates the relevant objectives of Transco's charging methodology, as set out in amended standard condition 4A of Transco's Gas Transporter (GT) licence. The reasons for this decision are set out in the accompanying paper.

The effect of this decision is that the reserve prices applying for entry capacity in the auctions for Monthly System Entry Capacity (MSEC) will be set at the same level as those set for the long-term allocations of Quarterly System Entry Capacity (QSEC). The same reserve prices will also apply to the rolling allocations of MSEC (RMSEC), held in the month before the month of use of capacity. These reserve prices are set out in Transco's Incremental Entry Capacity Release methodology.¹

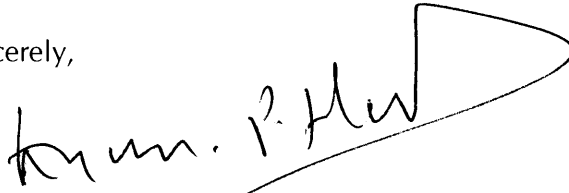
Reserve prices for sales of Daily System Entry Capacity (DSEC) will be set at two-thirds of the MSEC reserve price at each entry point. From 1 October 2003, the reserve price for daily firm system entry capacity sold on the day of use of the capacity will be set at zero, while the reserve prices for day-ahead sales will remain at two-thirds of the MSEC reserve prices. The reserve prices for Daily Interruptible System Entry Capacity will remain at zero.

The existing balance for exit capacity charges is unchanged by this proposal.

¹ Available on Transco's website at <http://www.Transco.uk.com>.

If you have any questions on this letter, or the accompanying paper, please call me on the above number, or Lyn Camilleri on 020 7901 7431.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Kyran Hanks', written in a cursive style.

Kyran Hanks
Director, Gas Trading Arrangements

Ofgem's views on Transco's proposal for NTS TO Entry Capacity Auction Reserve Prices and Exit Charges (PC 76)

Background

Transco has set reserve prices in previous short-term allocations of Monthly System Entry Capacity (MSEC) to its National Transmission System (NTS) on the basis of its Long-Run Marginal Cost (LRMC) methodology. The reserve prices were set at 75 per cent of the LRMC levels following Pricing Consultation (PC) 48.² Following PC 62, *'Daily System Entry Capacity Floor Prices'*, the reserve prices for DSEC have been set at two-thirds of the level of the MSEC reserve prices.

In September 2002, Ofgem implemented a system of System Operator incentives for Transco, which took effect from 1 April 2002. This regime included incentives to invest efficiently in additional entry and exit capacity.

Transco's potential revenues under the entry capacity investment incentive are determined in relation to pre-agreed Unit Cost Allowances (UCAs), set for each entry terminal and specified in Transco's Gas Transporter (GT) licence. These UCAs have been set as the reserve price applying in allocations of long-term entry capacity, the first of which is due to take place in January 2003, in which capacity out to 2017 will be made available for sale. This capacity will be offered in the form of Quarterly System Entry Capacity (QSEC). Shorter-term auctions will continue, with annual allocations of MSEC, a rolling monthly allocation for the month ahead (RMSEC) and day-ahead and within-day allocations.

As part of the entry capacity investment incentive arrangements, Transco is required to offer for sale the levels of its obligated entry capacity, made up of a series of baseline levels of capacity and any incremental capacity which Transco undertakes an obligation to make available. Transco must ensure that this capacity is offered in at least one clearing allocation, which is defined to be either an allocation in which the capacity is sold, or in which the reserve price is zero. This obligation is subject to Transco's wider licence obligations for network charging.

Under Transco's GT licence, it is required to use all reasonable endeavours to ensure universal firm registration of NTS exit capacity with effect from 1 April 2004.

Transco's initial proposal

Transco proposed to change the methodology for setting the reserve prices for MSEC auctions to the UCAs as set out in Transco's GT licence. It proposed that the MSEC reserve prices should be equal to the annuitised equivalent of the UCAs, assuming an annuity discount factor of 6.25 per cent per annum. DSEC reserve prices would continue to be set at two-thirds of the MSEC reserve prices at each entry point. Transco proposed no rebalancing of firm exit capacity charges until universal firm registration of NTS exit capacity is introduced.

² Pricing Consultation 48, *'Methodology for Determining Floor Prices for Auctions of Monthly System Entry Capacity'*, which was implemented on 8 September 1999.

Respondents' views

There were 14 responses to this consultation, with the majority of respondents supporting the proposal to align the methodologies used to set reserve prices in the short-term auctions with those used for the long-term allocations.

Methodology to apply for MSEC reserve prices

The majority of respondents supported Transco's proposal to apply the UCA methodology to derive MSEC reserve prices on the basis that this would ensure a consistent approach between allocations and avoid possible distortions.

Other respondents opposed the proposal on grounds including that the justification for applying reserve prices at all was not strong and because of concerns with the UCA methodology. A number of respondents called for Transco to explain the differences between the LRMC and UCA methodologies.

On the issue of whether the MSEC reserve prices should be set at the same level of the QSEC reserve prices or some proportion of the QSEC level, of those respondents who supported using a consistent approach, there was a slight preference for setting the reserve prices at the same level. Arguments made in support of this approach were that it would avoid providing incentives on shippers to secure their capacity in the short-term allocations rather than the long-term allocations or the secondary market and that it would avoid Transco under-recovering its allowed revenue.

Other respondents argued that the reserve prices applying in the short-term auctions should be lower than the long-term reserve prices to avoid Transco over-recovering, to reflect the risk associated with securing capacity short-term and to allow the market to clear.

Transco's obligation to offer capacity for sale in a clearing allocation

Respondents were fairly evenly divided in their views on whether the existing relationship between the reserve prices for DSEC and MSEC should be maintained, or whether a zero reserve should apply.

Exit capacity charges

The majority of respondents supported the proposal for no rebalancing of firm exit capacity charges until universal firm registration of NTS exit capacity is introduced.

Transco's views

Methodology to apply for MSEC reserve prices

In Transco's consultation paper, it submitted that the change in the methodology used for the MSEC reserve prices to the UCA approach would ensure consistency between the MSEC reserve prices and the QSEC reserve prices, thereby avoiding possible market distortions. Transco submitted that using inconsistent approaches might create an unintended incentive for shippers to participate in the MSEC auction or the QSEC auction, or vice versa, and so possibly distort the signals relating to demand at each entry point.

Transco stated that, were reserve prices to continue to be set on the basis of the existing LRMC methodology, the reserve prices would need to be substantially rebalanced, and that this rebalancing would in general be greater than the variation between the LRMC and UCA derived reserve prices.

Transco's obligation to offer capacity for sale in a clearing allocation

In Transco's consultation paper, it argued that the fact that a large proportion of capacity offered for sale in the past MSEC auctions has not been allocated suggests that there is a general lack of competition, given the level of capacity which has been offered. It suggested that, for the last two MSEC auctions, for entry points where all the capacity was not sold and where reserve prices were not zero, setting a zero reserve price in order to achieve a clearing allocation would have contravened Transco's wider licence obligations.

In Transco's report on PC 76, it distinguished between sales of DSEC made at the day-ahead stage with sales made on the day. It considered that there is justification for having positive reserve prices for allocations made ahead of the gas day, in order to prevent the impact of dominant players exercising market power and the associated significant revenue shortfall that that might entail. Transco considered that such revenue shortfall might require other transportation charges to be increased, which would have distributional effects, which might be considered to be unduly discriminatory.

However, Transco proposed to set zero reserve prices for capacity made available on the day, to take effect from October 2003. It stated that this would ensure that all obligated capacity can be offered in at least one clearing allocation.

Transco's final proposal

Transco's final proposal is that MSEC reserve prices should be equal to the baseline price for capacity offered in the QSEC allocations and that DSEC reserve prices will be set at two-thirds of the level of the QSEC prices. From October 2003, zero reserve prices will apply for sales of firm system entry capacity made available on the day of use, while the reserve prices for DSEC sales made at the day-ahead stage will remain at two-thirds of the MSEC reserve prices. The existing balance for exit capacity charges will remain unchanged, until universal firm registration of exit capacity is introduced.

Ofgem's views

Following the introduction in 1999 of auctions for entry capacity, Ofgem has consistently stated that reserve prices are only necessary in order address competition concerns. In the short-term allocations, we have considered that there is sufficient competition at the majority of large beach entry terminals to guard against significant revenue under-recovery. Our concerns with maintaining reserve prices related to the fact that reserve prices could prevent price discovery at competitive terminals and, by restricting price differentials between terminals, reserve prices could inhibit competition for capacity between terminals. We have also been concerned that reserve prices could prevent all capacity from being released to market. If entry capacity remains unsold or only sells at reserve prices, this could suggest that reserve prices are preventing the market from clearing.

In the context of allocations of incremental entry capacity, Ofgem has accepted the need for some form of floor price, in order to avoid the possibility of Transco having to commit to build

new capacity where the price offered in the auctions did not cover the costs associated with providing that capacity. Reserve prices are also justified in the long-term allocations of existing capacity in order to address the competition concerns of a limited number of players securing capacity at zero or low prices which does not reflect the value they place on the capacity.

Given that the reserve prices applying in the long-term allocations have been set at the UCAs, Ofgem agrees that the methodology used to set any reserve prices in the short-term allocations should be consistent with that used for long-term allocations. The alternative of retaining the LRMC methodology for short-term allocations would introduce some inconsistencies between the reserve prices applying between the long and short-term allocations. In this respect, Ofgem considers that the proposal better facilitates the relevant objectives of efficiency and promotion of competition between gas suppliers and gas shippers, by avoiding any possible distortions associated with introducing unintended incentives on shippers to secure their capacity needs in a particular allocation based on the applicable reserve price.

While Ofgem may continue to have concerns if the reserve prices applying in the short-term auctions are preventing price discovery and withholding capacity from the market, we consider that this proposal, incorporating a consistent methodology for reserve prices in long and short-term allocations, and a zero reserve price applying to capacity sales on the day from October 2003, is an improvement to the existing charging methodology. Applying zero reserve prices on the day will enable the market for capacity to clear, allowing the market to determine the price for capacity at each terminal. In setting zero reserve prices for within day sales, Transco will still be subject to its licence obligation to avoid undue preference in the supply of transportation services.

In conclusion, for the reasons given above, Ofgem has decided to not veto this proposal.