

18 October 2000

BG Transco, shippers and other interested parties

Our Ref:

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Dear Colleague,

NTS Capacity constraints and conduct in the buy-back market

I am writing to express concern about the behaviour of a number of shippers since 1 October 2000 in the capacity market and to offer guidance on what, in Ofgem's view, constitutes acceptable shipper behaviour in the capacity market. Ofgem will be writing to a number of individual shippers separately to ask them to explain their recent behaviour.

Ofgem reminds shippers that it has, or will shortly have, powers both under the Gas Act 1986 and the Competition Act 1998 to take enforcement action and to impose monetary penalties if shippers are in breach of relevant licence conditions or one of the prohibitions of the Competition Act 1998.

Background

From 1 October 2000, the amount of NTS monthly system entry capacity (MSEC) that BG Transco sold in the auction was increased to 10% above the previous year's level, which was based on expected system demand (Seasonal Normal Demand (SND)). As a result, when temperatures are higher than those assumed under seasonal normal conditions, the volume of gas that BG Transco can accommodate at NTS entry points, and particularly at the St Fergus terminal, is more likely to be below the level of MSEC sold at auction.

Under the current regime, and consistent with the rules specified in the Network Code, BG Transco must buy-back excess capacity in the event of a constraint. A constraint occurs when shippers have nominated against MSEC capacity holdings that, in aggregate, are in excess of Transco's actual capacity availability, given system conditions. Under the current incentive arrangements, BG Transco is exposed to 20% of the costs of any buy-back actions, subject to a monthly cap of £416K and an annual cap of £5million. The remaining 80% of any costs (or 100% of the costs once the cap is exceeded) incurred are smeared back to MSEC capacity holders in proportion to their MSEC holding relative to the total amount of MSEC sold in the monthly auctions.

In the first two weeks of October, the weather has been warmer than that assumed under the SND methodology and this has been the main driver of capacity constraints and capacity buy-backs by BG Transco.

In the period since 1 October 2000, BG Transco has bought back over 1000 GWh of entry capacity at prices ranging between 0.26 p/kWh (7.6 p/therm) to 1.5 p/kWh (45 p/therm). The overall cost of the buybacks is now in excess of £7 million and as Transco's monthly cap has now been breached, these significant costs are being born by all shippers.

The regulatory framework

Ofgem would remind all shippers that they need to have in place compliance arrangements to ensure that their behaviour does not breach competition law or their Gas Shipper's Licences.

Under the Competition Act 1998, the Director General has concurrent jurisdiction with the Director General of Fair Trading in exercising the functions and powers of the DGFT. The Chapter II prohibition of the Act prevents the abuse of a dominant position by one of more persons.

Standard Condition 2(2) of the Gas Shippers' Licence requires that the licensee shall not knowingly or recklessly pursue any course of conduct that is likely to prejudice:

- a) the safe and efficient operation, from day to day, by a relevant transporter of its pipeline system;
- b) the efficient balancing by the transporter of its system; or
- c) the due functioning of the arrangements provided for in its network code.

Standard Condition 2(3) of the Gas Shippers' Licence requires that the licensee shall not knowingly or recklessly act in a manner likely to give a false impression to a relevant transporter as to the amount of gas to be delivered to that transporter's pipe-line system or as to the amount of gas to be comprised in its off-takes of gas.

Shippers also have a number of obligations under the network code. A shipper in breach of a network code obligation could be found to be in breach of Standard Condition 2(2) of their licence. In particular, section I 3.10.1. taken with I 3.10.2 of the Network Code requires shippers to use all reasonable endeavours to ensure that gas delivered to the System is delivered at a rate that is constant apart from as a result of a renomination, and is at the Implied Nomination Flow Rate. The Implied Nomination Flow Rate is defined in C 1.9., and is generally the one-twentyfourth part from where there has been a renomination during the Day in which case it is the Quantity divided by the remaining hours in the Day. As an assumption at the start of a Day however it would be fair to assume that the one-twenty fourth rule is in play. Shippers are reminded that a breach of obligations under the Network Code could be found to be a breach of Standard Condition 2(2) of their licence and that unexplained flows of gas in excess of nominated volumes could be in breach of Standard Condition 2(3).

Guidance on shipper behaviour in the entry capacity buy-back market

Ofgem believes that there are three areas in which shippers will need carefully to consider their behaviour and conduct in the light of these obligations: nominations, capacity overruns and bids to sell back capacity to Transco.

Nominations behaviour

Ofgem has looked at the nomination behaviour of shippers flowing through St. Fergus since the constraint occurred. Ofgem is concerned that a number of shippers have substantially increased nominated gas inputs through the St. Fergus terminal since the constraint became apparent despite no significant change in system demand during the first three days.

BG Transco has also reported to Ofgem that actual gas flows through St. Fergus on a number of days of the constraint has been, early in the gas day, far in excess of shippers flow nominations. Again, this has increased the size of the constraint and the volume of entry capacity that BG Transco has had to buy-back on the day.

Ofgem would remind shippers' of their obligations under standard condition 2. In particular, Ofgem believes that seeking to exacerbate a constraint through nominations significantly in excess of MSEC holdings may constitute a breach of Standard Condition 2. Ofgem would also remind shippers that under the Network Code they have an obligation to use reasonable endeavours to flow at a constant rate. Front loading of physical gas deliveries may also constitute a breach of the Network Code and the licence.

Ofgem will be continuing to monitor shippers' nomination patterns and physical flows through the duration of the capacity constraint and will take action if it appears that one or more shippers appears to be or is likely to be in breach of their licence.

Capacity overruns

On the 30 August 2000, Ofgem wrote to all shippers highlighting our concerns regarding the incidence of several capacity overruns in recent months and to remind shippers of their licence obligations relating to overruns. We made clear that, in our view, consistently overrunning at a terminal where the shipper has failed to purchase capacity could constitute a breach of Standard Condition 2 of the Gas Shippers' Licence. Ofgem would be particularly concerned if shippers were consistently overrunning at the St Fergus terminal during a period of a constraint.

Bidding behaviour

In assessing bidding behaviour by shippers, Ofgem will analyse behaviour against that which might be expected from a company absent any market power. Companies whose bidding behaviour deviates substantially from such a pattern may, in Ofgem's view, be in breach of competition law or of the licence obligation not to prejudice the efficient balancing of the system by Transco. In this section we have set out guidance on how we would assess shipper's bidding behaviour on this basis.

Under the current rules, when shippers purchase MSEC in the monthly auctions they are clearly aware that they are buying a bundled product with three distinct elements: a firm right to flow gas against the MSEC holding (which can be sold to Transco or other shippers, a right to receive a fixed share of revenues from daily sales of capacity at the relevant terminal and an obligation to pay for a fixed share of the costs of any daily capacity buy-backs as a result of NTS constraints. Ofgem would expect shippers to factor the values of these rights and obligations into their bid prices when bidding for MSEC in the monthly auctions.

Having secured an MSEC entitlement in the monthly auctions, we would expect a company, in a competitive market, to view its share of any constraint costs to be effectively fixed. We would not expect a shipper to be able to substantially influence the capacity buy-back price in the event of a constraint.

A shipper, in determining the price at which it was willing to sell capacity back to Transco, would appropriately reflect the marginal opportunity cost (or avoidable costs/lost profit) of releasing the capacity. If the shipper's bid was below the marginal bid of other shippers, the bid would be called and the shipper would be paid his opportunity cost for selling the capacity back to Transco. The total cost of the constraint would then be lower than it would have been if the shipper had not offered its capacity and, as a result, the shipper's own share of the cost of the constraint would be lower. Conversely, if the shipper's bid was above the marginal bid of other shippers, Transco would not buy the shipper's capacity because it placed a higher value on the capacity than other shippers. The price at which Transco bought out the constraint would be lower than the shipper's own opportunity cost and the shipper's fixed share of the cost of the constraint would be lower than it would have been if its own bid had been accepted.

As a result, Ofgem does not believe that it is legitimate for shippers to seek to factor up their bid prices in relation to opportunity costs in an attempt to mitigate their exposure to the smear back of constraint costs. In a competitive market, a shipper would not be able to influence the market price for buy backs and would simply bid to reflect opportunity cost.

We acknowledge that the opportunity cost of entry capacity is likely to be different for individual shippers and also that it may be significantly higher than the purchase price paid for the capacity in the monthly auction. We also acknowledge that the opportunity cost of entry capacity may increase over time during a period of a constraint as, for example, companies may be obliged to make up volumes under gas supply contracts or face take-or-pay liabilities.

At the lower end, the opportunity cost of excess capacity surplus to the needs of the shipper (for both contracted and spot trading purpose) is the price at which it could trade that capacity away to another shipper. Ofgem has seen that on a number of days when BG Transco was buying back for commercial reasons (to release capacity at another terminal), the price to BG Transco of St. Fergus capacity was 0.083 p/kWh (2.5 p/therm)¹. If a shipper held excess entry capacity, we would expect any non-zero price for capacity to be acceptable.

At the higher end, the opportunity cost of entry capacity may be associated with the costs of failing to land gas under a long-term take-or-pay contract obligation to supply a contracted off-take position. For such entry capacity, the opportunity cost is likely to be the spot price of acquiring gas NBP. This is because in the absence of a the constraint, the shipper would have to pay the contract price and the entry price but with the constraint it would have to pay both these elements and, in addition, have to purchase gas at spot prices to cover the supply commitment. Ofgem estimates that, on the first three days of the constraint at current spot prices, this may have resulted in an opportunity cost of around 0.9 p/kWh (27 p/therm). Ofgem would only expect that a shipper offering marginal capacity would bid in a price reflecting such a cost if it had absolutely no flexibility under its gas supply contracts and no entry capacity in excess of its contracted supply positions.

¹ Prices paid by BG Transco on 12 June 2000.

Conclusion

Ofgem will continue to monitor the entry capacity market, nominations and overruns. We will take appropriate action if it appears that any shipper is breaching its licence obligations and/or competition law. Shippers are reminded that where the Director General is satisfied that a licensee is contravening, or is likely to contravene, any relevant conditions or requirement, the Gas Act obliges him (except in specified circumstances) to issue an enforcement order against the licensee under section 28 of the *Gas Act*. In making an enforcement order under section 28, the Director General may impose on the licence holder to whom the order relates, a requirement to pay a monetary penalty of such amounts as may be appropriate.

Ofgem would urge all shippers to ensure that they have appropriate compliance arrangements in place. If anyone has any queries or questions relating to the guidance offered in this letter, please contact me at the number above or Mark Feather on 020 7932 6337.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Steve Smith', with several overlapping loops and a long horizontal stroke at the end.

Steve Smith
Director, Trading Arrangements