

## Developing a more efficient gas pipeline network: long-term entry capacity auctions

Ofgem has approved a series of auctions for long-term entry capacity on the National Transmission System (NTS), the pipeline network that transports gas around the country.

### Key benefits long-term auctions will bring

#### Customers will benefit from:

- a pipeline system that develops in such a way as to increase efficiency and security of supply

#### Transco will benefit from:

- better signals to guide its investment in the NTS to meet the changing demands placed on the system
- these signals will begin to replace the information currently received from the industry in planning its investment programme

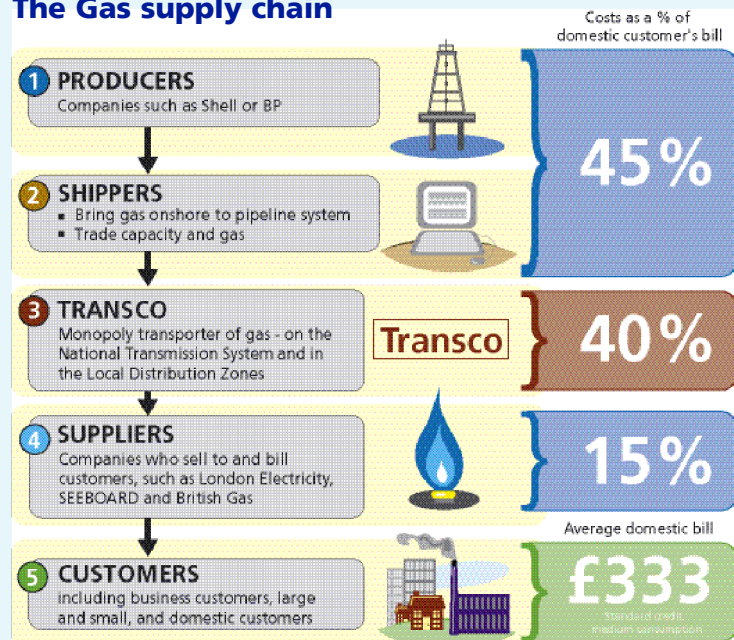
#### Industry will benefit from:

- firm access rights to the NTS giving shippers and producers certainty for up to 15 years ahead as to how much gas they can bring on to the system

## How is gas transported around Britain?

All of Britain's gas currently comes from offshore gas fields in the North and Irish seas or is imported from Europe through an interconnector pipeline. Shipping companies arrange for gas to be introduced into, conveyed and taken out of the pipeline system. The gas they buy from the producers is brought ashore at a series of terminals around the country. These terminals then deliver the gas onto the NTS, which is owned and run by Transco.

## The Gas supply chain



## What is entry capacity?

Transco's terminals can only flow a certain amount of gas on to the NTS system at any one time, this is known as entry capacity.

## Keeping the system in balance

Transco has to ensure that the NTS is always balanced with enough gas being brought onshore to meet demand.

If shippers want to put more gas onto the system than is physically possible, Transco may manage this constraint by buying back entry capacity from shippers at market prices. These buy-back costs are spread across shippers, based on their holdings of capacity.

## What are the issues with the development of the gas network?

- In recent years concerns have been voiced by industry about the costs they have incurred as a result of constraints on entry capacity.
- These costs will affect transportation costs, which make up around 40 per cent of domestic customers bills.
- It is vital that the NTS expands efficiently to meet demand and changing patterns of supply in order to ensure security of supply and to prevent costs from rising.

## What is Ofgem's role?

Ofgem has a duty to ensure that security of supply is maintained and to protect customers' interests. Consistent with this duty, Ofgem is seeking to ensure that Transco invests in increasing entry capacity as efficiently as possible and that customers benefit from long-term access arrangements to the pipeline system.

## Incentives on Transco to increase investment

Ofgem set new incentives for Transco under its System Operator scheme that came into force in April 2002. The scheme gives Transco a financial incentive to invest in increasing the entry capacity of those terminals that the auction process shows are most in demand by shippers.

The scheme also provides funding for Transco to make an agreed amount of capacity available at each terminal. It can earn 6.25 per cent revenue from this capacity. If Transco does

not deliver this capacity it will have to buy the capacity back at market prices and will be exposed to some of the costs of these buy backs. If the auctions show that there is demand for more capacity at a terminal, Transco can expand the terminal's ability to handle this extra capacity. Transco can almost double its earnings to 12.25 per cent on this extra capacity giving it a strong incentive to invest in expanding the system where demand is strongest.

## Why auction?

At the moment entry capacity is sold through short-term auctions, which sell monthly and daily capacity rights. The introduction of long-term auctions should provide the industry with more certainty and improve the market signals Transco receives to help it make efficient investment decisions.

Other alternatives, such as central planning or bilateral contracts, do not provide the advantages that auctions offer:

- a fair and transparent method to allow shippers and producers to get their gas onto the NTS
- a chance for every shipper to compete equally and fairly for entry capacity

- an efficient way to allocate entry capacity to those shippers who value it most, and
- investment signals for Transco by showing which terminal's capacity is most in demand and would benefit from further investment to increase its capacity.

Long-term capacity auctions should meet the concerns of customers and industry about the costs incurred as a result of constraints on Transco's system. Improved signals and incentives on Transco to invest in the NTS will reduce costs and expand entry capacity at the right places to meet future demand.

## How will auctions work?

Transco will auction entry capacity at each of its terminals for up to 15 years ahead. Capacity will be released in quarterly and monthly blocks through a combination of long and short-term auctions. However, 20 per cent of the entry capacity will be reserved and only auctioned off a year ahead of use. Shippers will also be able to secure capacity on a daily basis. This allows new entrants to the market access to the NTS network.

In the long-term auctions Transco will publish prices for different levels of entry capacity available at each terminal.

This will also include prices for increasing the entry capacity at each terminal by up to 50 per cent.

Shippers will bid for entry capacity at these prices. Transco will use this information to inform investment plans for its system. Shippers will then be allocated entry capacity rights at a common price for each quarter at each terminal.

The logo for Ofgem, consisting of the word "ofgem" in a white, lowercase, sans-serif font inside a rounded orange rectangle.

## How does gas reach our homes?

### Demand for gas

Demand for gas in Great Britain has grown. We now use 66 per cent more gas in this country than we did in 1992. A lot of this is used to generate electricity. Electricity generation accounts for 32 per cent of gas used in the country.

