November 2001

# Ofgem's investigation into shipper conduct in the capacity market in October 2000

## Conclusions

## Summary

This document sets out the conclusions of Ofgem's investigation into gas shipper's conduct in the market for entry capacity to Transco's National Transmission System (NTS). The NTS is the network of high pressure pipelines that transport natural gas in bulk across Great Britain (GB).

In October 2000, Transco experienced a period of constraints on the NTS, particularly at the St Fergus terminal in Northern Scotland which accounts for a significant volume of GB's gas supply. During October, Transco did not have sufficient entry capacity physically available to meet its contractual commitments to shippers. Transco had auctioned firm entry rights to shippers at all entry terminals in August for the six months from October 2000 to March 2001.

Under the capacity arrangements set out in Transco's Network Code, the contract that governs the terms on which companies can gain access to, and use of, the NTS, Transco is obliged to buy back capacity it has sold but cannot physically accommodate on the day. Transco has commercial incentives to manage the costs associated with any capacity buybacks and constraints. Under the incentives in place at the time, Transco was exposed to 20% of the costs of any capacity buybacks, subject to annual cap on its exposure of £5m divided into twelve equal monthly caps.

During the periods of constraint, Transco was required to buy-back significant volumes of capacity from shippers holding entry capacity, often at very high prices. During October 2000, Transco incurred costs of over £8.5m in a period of 20 days.

Ofgem announced it was investigating shipper conduct in the buy back market late in October2000. Ofgem had previously issued guidance to shippers on their conduct in the capacity market. For example, early in October 2000, Ofgem had written to shippers setting out guidance about what, in our view, would constitute acceptable shipper behaviour in the capacity market and reminding them of their obligations under their licences and competition law.

In reviewing buy-back prices, Ofgem sought to determine whether there was any evidence of anti-competitive behaviour by shippers as a result of their conduct in the buy-back market.

Ofgem's investigation focused on two issues: whether any shippers had consistently flowed more gas onto the system than they were contractually entitled to (known as 'overrunning'). Consistently overrunning could increase the level of constraints and the costs of alleviating them. The second issue was whether any shippers' conduct (and in particular the prices at which capacity was sold back to Transco compared with the prices capacity was sold on the secondary market) was anti-competitive and/or harmful to customers.

Ofgem's initial analysis provided some evidence that indicated that five shippers had overrun on a number of occasions and were potentially in breach of their shipper's licence. Ofgem also found that five shippers may have engaged in discriminatory pricing behaviour that could have distorted competition and/or been harmful to customers.

In subsequent, more detailed discussions, all of these companies were able to provide satisfactory explanations for their conduct. Those shippers who had overrun against their capacity bookings were either able to demonstrate that the overruns were the result of genuine errors and that they had put in place adequate systems and procedures to ensure that they would not overrun in future or that they had not correctly notified trades and that they held sufficient capacity at a company level to meet their gas flows.

In responding to the concerns raised by Ofgem regarding potential pricing behaviour, each shipper was able to provide evidence that that the higher prices offered to Transco reflected changing market conditions during the day and the opportunity costs of releasing capacity back to Transco at the time of the sale. Ofgem, in reviewing this evidence, was able to conclude that the pricing behaviour of the shippers concerned was consistent with the guidance we had issues and what could be expected in in a competitive market.

Ofgem accepted the arguments raised by a number of shippers that although the prices paid by Transco to buy back capacity were initially very high, they were not sustained and prices declined as competition to sell capacity back to Transco between shippers emerged. The constraints in October 2000 lead to the first sustained period of buy backs since the new arrangements were introduced in October 1999. As a result, it took some time for shippers and Transco to learn about the dynamics and operation of the capacity buy back market.

Ofgem therefore concluded that no further investigation and/or action was required.

During its investigation Ofgem has identified a number of elements of the capacity regime that could be improved to increase the efficiency of the market. These include developing Transco's buy-back market systems and better risk management by Transco through the use of forward option contracts to buy back capacity from shippers. Ofgem's proposals to introduce new System Operator incentives from April 2002 and new long term capacity rights will strengthen the incentives on Transco to develop the arrangements and manage the costs and risks associated with constraints and buy backs more efficiently.

Ofgem will continue to monitor shipper conduct in the capacity and gas markets as part of its ongoing wholesale market surveillance.

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# 1. Introduction

### *Purpose of this document*

1.1 In October 2000, the Office of Gas and Electricity Markets (Ofgem)[1] initiated an investigation into activities in the National Transmission System (NTS) entry capacity market on a number of days during which Transco experienced severe constraints on the NTS (and in particular at the St Fergus entry point).

1.2 This document sets out the analysis Ofgem completed as part of the investigation, our preliminary findings and our conclusions.

### *The NTS entry capacity investigation*

#### Background

1.3 On 1 October 1999, new entry capacity arrangements on Transco's NTS were introduced as part of the new gas trading arrangements. The arrangements included:

- an efficient, non-discriminatory method of selling financially firm entry rights to the NTS related to the physical capacity available. This was achieved through a series of auctions for monthly and daily entry capacity rights at each of the major entry points to the NTS; and

- new commercial incentives on Transco to ensure that all capacity is released to market on non-discriminatory terms and that Transco minimises the costs of any network constraints.

1.4 During the first year of the new arrangements, Transco bought back entry capacity on 30 days at a total cost of £1.1 million. During the period of constraints in October 2000, Transco was unable to deliver against the firm capacity it had sold in the monthly auctions. Transco had to buy-back significant volumes of capacity in the capacity market often at very high prices, at a total cost of £8.5m.

[1] The Gas and Electricity Markets Authority (GEMA) has the ultimate responsibility for all Ofgem activities and is responsible for determining strategy and major policy issues.

1.5 Under the capacity incentive in place at the time, Transco was exposed to 20% of the costs of buy-backs, subject to an annual cap of £5 million and a monthly cap of £416 000. Transco also received 20% of the revenues associated with daily capacity sales. During October 2000 Transco reached its monthly cap for buy-backs in only three days. The remaining £8.1 million of buy-back costs incurred during October were smeared across all shippers holding monthly entry capacity.

1.6 Transco was required to buy-back capacity in October 2000 as gas demand was lower than usual in the month of October as a result of warmer than average weather for the month. Lower gas demand on the system as a whole reduced the amount of capacity physically available at the Northern entry terminals. During periods of lower demand, gas tends to be exported through the interconnector with Belgium that is located in the south of the country, at Bacton in Norfolk. During periods of lower domestic demand but higher exports, there is often a constraint on the amount of gas that can be transported from one extremity of the system to another.

### *Rationale*

1.7 Ofgem has a statutory duty to protect customers' interests by promoting competition in energy markets, wherever possible. Ofgem also has concurrent powers with the Office of Fair Trading (OFT) under the Competition Act 1998.

1.8 Ofgem therefore undertakes routine monitoring and surveillance of the wholesale gas and electricity markets. This surveillance seeks to identify and assess potential market abuse and/or conduct that could have anti-competitive effects and harm customers' interests. Market surveillance can also highlight potential problem and issues with the market rules relating to wholesale markets and help to identify the need for change.

1.9 Where evidence is found of potential anti-competitive behaviour, Ofgem investigate further and considers whether it is necessary to take any action as a result of any investigation findings.

1.10 Ofgem's market monitoring is critical to ensuring that markets remain competitive and free from abuse and deliver value for money to customers.

### *The Investigation process*

**Preliminary investigation**

1.11 On 17 October 2000 Ofgem wrote to all shippers expressing concern about the high prices offered by some shippers in the capacity buy-back market (see Appendix 2 for a copy of this letter). On 23 October 2000 Ofgem issued a formal information request to shippers in accordance with Standard Condition 9,[2] of the Gas Shippers Licence. The information required was the volume, price, location and the names of counter parties for all trades of monthly firm capacity rights for capacity to be used between 1 October and 23 October 2000. A copy of this information request appears in Appendix 3. Similar data was also requested from Transco to enable Ofgem to validate information submitted by shippers and ensure consistency in responses.

1.12 Ofgem found that a number of shippers had provided incomplete information or information that was inconsistent with Transco's data. As a consequence, it was necessary to seek further clarification from a number of shippers in order to reconcile shipper and Transco data. This process took a significant amount of time and delayed the completion of the initial phase of Ofgem's investigation.

**Ofgem's analysis**

1.13 Ofgem's investigation focused on two issues:

- whether any shippers had consistently flowed more gas onto the system than they were contractually entitled to (known as 'overrunning') as this would increase the level of constraints and the costs of alleviating them; and
- whether any shippers conduct (and in particular the relative prices at which capacity was sold back to Transco compared with secondary market prices) was anti-competitive and/or harmful to customers.

[2] Following changes introduced by the Utilities Act 2000, the obligations that previously appeared in Standard Condition 9 now appear in Standard Condition 10 of the Gas Shippers' licence.

*Shipper Overrun investigation*

1.14 Ofgem's initial analysis of shipper overruns was completed in February 2001. This analysis provided evidence that some shippers had consistently overrun on a number of occasions, with some shippers overrunning on days when the system was constrained. This evidence pointed to a possible breach of the provisions of the then Standard Condition 2 of the Gas Shipper's licence. On 22 February 2001 Ofgem wrote to a number of shippers to seek an explanation of their overruns. These shippers were:

- Accord;
- Total Fina Elf;
- Conoco;
- Scottish and Southern Energy; and
- Innogy.

1.15 Following meetings with these shippers and, in some cases, exchanges of correspondence, Ofgem then wrote to each shipper to inform them of its conclusions.

1.16 Ofgem was satisfied with the explanations of overruns provided by the five shippers that were the subject of the investigation. In particular, Ofgem accepted that in several cases, the overruns were the result of administrative or operational errors. In these cases, shippers were able to provide evidence that they had taken steps to improve their internal systems and processes to significantly reduce the possibility of overrunning as a result of errors in the future.

1.17 Two of these shippers indicated that a number of their overruns were the result of over-delivery of gas (relative to shipper nominations) by Marathon Oil UK Ltd ('Marathon'). Marathon wrote to Ofgem and explained that Marathon, a licensed shipper, had posted the additional gas to the Claims Validation Authority in error. Marathon made clear that it intended to nominate the gas under its own shipper account as it held sufficient monthly capacity to flow the gas onto the system.

1.18 All of the shippers investigated had faced significant overrun charges under the terms of the Network Code that reflected the costs incurred by Transco in buying back capacity on the days that the overruns occurred.

1.19 In summary, all of the overruns were the result of errors that had led to shippers facing commercial penalties under the Code. Shippers who had overrun indicated that they were seeking to improve their systems and processes to reduce the possibility of future error. Ofgem was therefore able to conclude that no shippers had breached their obligations under their licenses.

**Pricing behaviour in the capacity buy-back market in October 2000**

1.20 Ofgem's initial analysis was completed in February 2001. Ofgem's preliminary analysis highlighted a number of possible concerns with the conduct of several shippers during the periods of constraints.

1.21 On 22 February 2001 Ofgem wrote to a number of shippers to invite them to discuss their trading behaviour. Each shipper was provided with an opportunity to present evidence to Ofgem to explain their behaviour in the buy-back and secondary markets. These shippers were:

- British Gas Trading;
- Total Fina Elf;
- Amerada;
- Powergen; and
- Enron.

1.22 Following meetings with these shippers and, in some cases, exchanges of correspondence, Ofgem then wrote to each shipper to inform them of our conclusions.

*Conclusions*

1.23 In reaching its conclusions Ofgem assessed the conduct of each individual shipper against a benchmark of what it would expect to see in a competitive process and, on the evidence provided in the process described above, found there to be no evidence of any anti-competitive behaviour by any of the shippers concerned.

1.24 In a competitive process Ofgem would expect to see the price at which capacity is bought back from shippers by Transco reflecting the opportunity costs to shippers of releasing capacity. Ofgem accepted that the higher prices offered to Transco by the shippers, identified above, reflected market conditions and the opportunity costs of forgoing capacity prevailing at the time.

1.25 Ofgem accepted the arguments raised by a number of shippers that although the prices paid by Transco to buy back capacity were initially very high, they were not sustained and prices declined as competition to sell capacity back to Transco between shippers emerged. The constraints in October 2000 lead to the first sustained period of buy backs since the new arrangements were introduced in October 1999. As a result, it took some time for shippers and Transco to learn about the dynamics and operation of the capacity buy-back market.

### *Outline of the document*

1.26 In chapter two of this document we explain the current arrangements for NTS entry capacity. Chapter three details the buy-back actions taken by Transco which lead Ofgem to initiate the NTS entry capacity investigation. Chapter four describes the investigations into individual shippers. Chapter five presents Ofgem's investigation into shipper overruns. Chapter six outlines Ofgem's final conclusions and way forward.

1.27 In appendix one we set out the regulatory framework, which forms a background to this investigation. In appendix two we reproduce the guidance that Ofgem has issued to shippers about conduct in the capacity market. In appendix three, we reproduce Ofgem's information request sent to shippers as part of the investigation.

### *Way forward*

1.28 The investigation has highlighted a number of areas of the current arrangements that could be improved. These improvements would ensure that, in the event of future constraints on the NTS at entry, Transco is able to manage the costs associated with them more efficiently. Ofgem's proposals to introduce new System Operator incentives on Transco from April 2002 are designed, in part, to address some of the lessons learned from the period of constraints last October.

**Transco System Operator incentives proposals**

1.29 Ofgem published its initial proposals for the SO incentives from April 2002 in September 2001.[3] The proposals set out in this document are intended significantly to improve the incentives on Transco to invest to expand the NTS in a timely fashion in response to its customers' changing needs. The proposals are also intended to improve the incentives on Transco to carry out its day to day role of operating the NTS economically and efficiently. This should see a reduction in the cost of system operation over time, to the benefit of customers, who ultimately pay these costs.

1.30 Under the proposals, Transco will have much stronger commercial incentives to invest to meet demand for entry capacity. Under the proposals, longer term, firm tradable entry capacity rights for shippers will be introduced. The initial sale of those rights through auctions and subsequent secondary trading should produce better signals of the need for additional investment. The new commercial incentives on Transco will encourage Transco to respond to these signals. This should reduce the likelihood of significant network constraints occurring in future as a result of unanticipated changes in the patterns of delivery of gas onto the NTS.

1.31 In the shorter term, Ofgem is proposing to enhance the existing incentives on Transco to manage the costs associated with network constraints. Ofgem is also proposing to give Transco greater freedom to develop new contractual tools to manage the risks and costs associated with entry constraints. Ofgem is proposing to increase the potential rewards to Transco associated with efficient

[3] *'Transco's National Transmission System – System Operator Incentives 2002-7 – Initial Proposals'*, Ofgem, September 2001.

management of buy back costs.  Ofgem is also proposing to increase Transco's exposure to the costs of buy backs.

1.32 Ofgem intends to publish its final SO incentives proposals in December 2001.

# 2. Background: The current NTS entry capacity arrangements

### *Introduction*

2.1 In this chapter we outline the current NTS entry capacity arrangements. We describe how this regime provides shippers with the ability to book firm and interruptible access rights at all of the NTS entry points. The arrangements are designed to provide shippers with strong commercial incentives to purchase entry capacity prior to flowing gas (the 'ticket-to-ride' principle).

2.2 We also describe Transco's commercial incentives under the arrangements. These incentives are designed to ensure that Transco makes all NTS entry capacity physically available through a combination of monthly, daily and within day sales of capacity. They are also designed to ensure that Transco manages the costs associated with capacity buy backs as a result of any network constraints.

2.3 The main principles underlying the current NTS entry capacity arrangements are to provide:

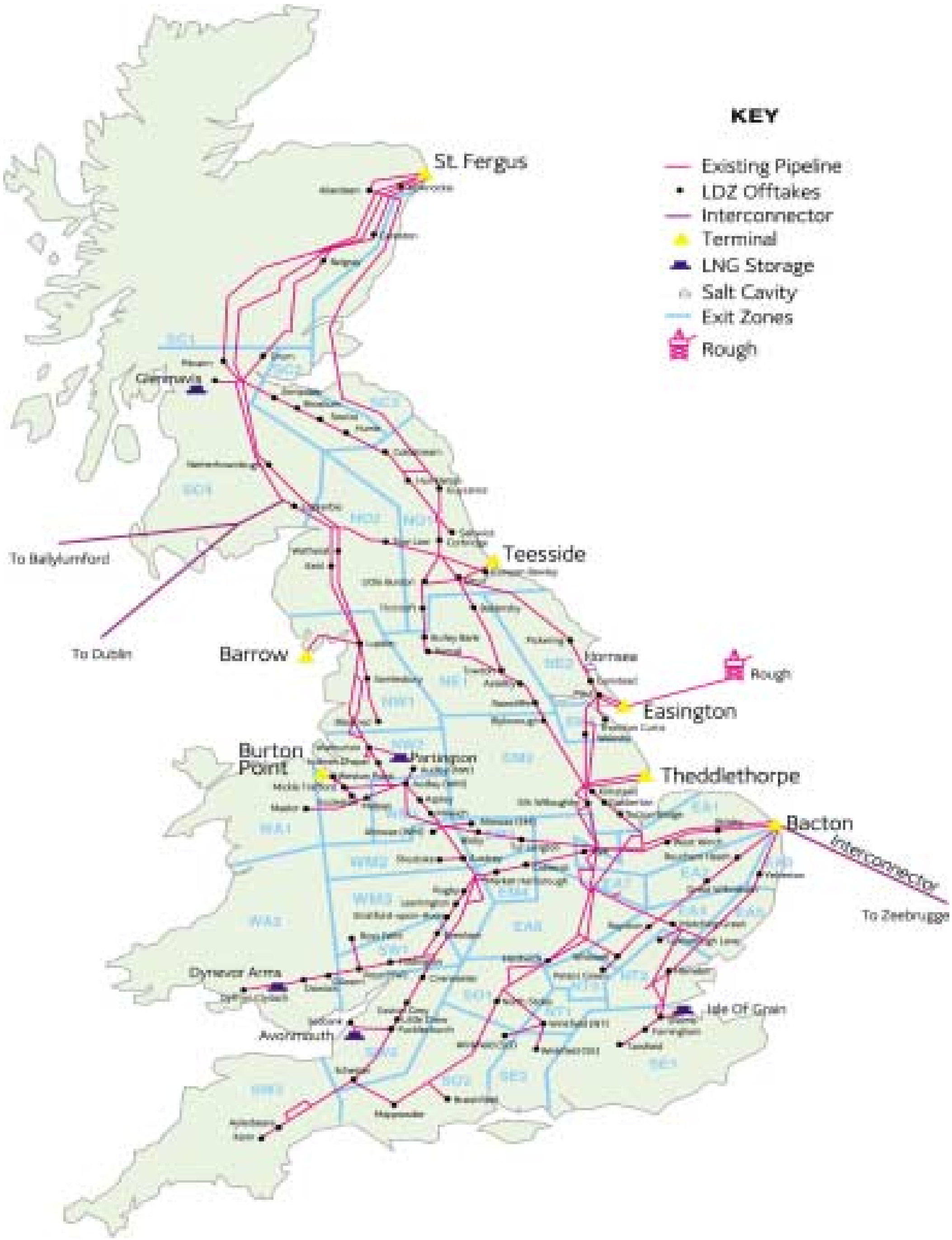
- an efficient, non-discriminatory method of selling financially firm entry rights to the NTS through a series of monthly and daily price auctions of firm entry capacity;
- appropriate anti-hoarding measures through the sale of monthly and daily interruptible entry capacity rights based on estimates of unused firm capacity (the 'use-it-or-lose-it' principle);
- Transco and shippers with commercial incentives to ensure the efficient day-to-day management and operation of the capacity regime.

### *The National Transmission System*

2.4 Entry rights are sold to all of the entry points to the NTS. There are five major beach entry terminals: Bacton, Barrow, Easington, Teesside, Theddlethorpe and St Fergus. There are also a number of onshore entry points including the

Hornsea and Hatfield Moor storage facilities and Transco's five Liquified Natural Gas Facilities. These are shown in Figure 2.1 below.

**Figure 2.1 - Map of the NTS**




### *Firm NTS entry capacity rights*

2.5 Transco makes firm capacity available both at the monthly and day-ahead stage. Transco can also sell additional firm capacity within day. Entry capacity rights are financially firm. In the event of a network constraint, where Transco is unable to meet its capacity obligations, it must buy back rights from shippers at market prices. Transco may in exceptional circumstances (for reasons of system security and safety) issue Terminal Flow Advice (TFAs) within day to curtail or constrain gas flows at particular entry points. Shippers are entitled to compensation under the Network Code in the event that Transco issues a TFA and Ofgem monitors the Transco's use of TFAs.

**Monthly system entry capacity – monthly booking**

2.6 Prior to the latest series of auctions for Winter 2001/2, the volume of entry capacity made available in the monthly auctions was based on an Seasonal Normal Demand (SND) profile. This assessed aggregate capacity available under average temperature and demand conditions each month. Aggregate capacity was then allocated between terminals on the basis of average flows over the last three years.

2.7 On 9 August 2001 Ofgem accepted Network Code Modification Proposal 0481, *Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction'*. This modification adjusted the methodology for determining the volume of capacity released for sale in the monthly system entry capacity ('MSEC') auctions for the period 1 October 2001 to 31 March 2002.

2.8 The modification provided for the release of MSEC quantities for each Aggregate System Entry Point (ASEP) for each month at a level equivalent to the highest of the monthly ASEP Maximum System Entry Capacities published by Transco in its auction invitation letter on 29 June 2001. The effect of the modification is to release closer to the maximum physical entry capacity at each entry point in the monthly auctions.

2.9 The monthly auctions to date have allowed participants to purchase capacity for a period of six months.[4] The auctions take place over five rounds. In each of the first four rounds, one quarter of the total volume of available capacity is made available for each of the six months. In the fifth 'flexible' auction round, any capacity that is unsold after the initial four rounds is made available and can

[4] The auction rules are set out in Transco's Network Code.

be allocated at any of the terminals (up to a specified maximum level of capacity).

2.10 Capacity is allocated to shippers on a pay-as-bid basis. Reserve prices are set at each terminal at a level of 75% of Transco's estimate of its long-run marginal cost ('LRMC') at each terminal.

**Daily system entry capacity – daily booking**

2.11 In addition to purchasing entry capacity in the monthly auctions, participants are able to purchase firm entry capacity on a daily basis from Transco. The daily market for capacity allows Transco to release additional capacity at the day-ahead stage (and within day) to ensure that all capacity is ultimately released to the market.

2.12 Under the Network Code, Transco has strong commercial incentives to make all capacity physically available to the market. Under this capacity incentive Transco faces a capacity incentive performance measure (CIPM) which is based on the net cost (or revenue) of actual costs of capacity buy-backs and incremental sales revenue compared to an ex-ante forecast. Where actual costs are lower (higher) than the forecast Transco obtains rewards (penalties). This capacity incentive was introduced through Modification proposal 488, *'Redesign of Capacity Incentive Regime'.* Ofgem accepted this proposal on 24 August 2001.

2.13 Prior to the introduction of this proposal Transco received under its incentives 20% of the revenues associated with daily sales of capacity. Transco's exposure under this regime was capped at £5 million per annum with a monthly cap of £416,000.

2.14 On 1 June 2000, a new within-day capacity mechanism was introduced that allowed Transco to sell additional firm entry capacity during the gas day. This mechanism allows both shippers and Transco to fine-tune their positions in response to events within-day. Reserve prices for day-ahead and within-day capacity are set at a 50% discount to Transco's LRMC levels.

### *Interruptible entry capacity bookings*

2.15 Transco also offers for sale interruptible capacity rights through auctions of monthly and daily capacity rights. Shippers do not receive any compensation if Transco interrupts these capacity rights.

**Monthly interruptible system entry capacity**

2.16 Under the current regime Transco is required to make available interruptible capacity at the monthly stage equal to the difference between the available monthly firm capacity and the 1 in 20 peak level of demand (the maximum physical level of capacity). This interruptible capacity is offered for sale in a pay-as-bid price auction, for a period of six months. The auction is conducted over two rounds with two working days between each round. In each round, 50% of the total available capacity is made available with any unsold monthly interruptible capacity offered for sale in the daily capacity auctions. Reserve prices for monthly interruptible capacity are set at a 90% discount to LRMC levels.

2.17 The auctions for monthly interruptible entry capacity are held after the auction of monthly firm entry capacity.

**Daily interruptible system entry capacity**

2.18 Transco also offers interruptible capacity at the day-ahead stage and comprises of any unsold monthly interruptible capacity and 'use-it-or-lose-it' capacity (UIOLI). Reserve prices for daily interruptible capacity are set at zero.

2.19 Transco's 'use-it-or-lose-it' regime seeks to address concerns regarding possible hoarding of entry capacity by shippers. 'Use-it-or-lose-it capacity' (UIOLI) is made available by Transco on an estimate of the level of MSEC that has been purchased by shippers but that Transco expects will not be utilised by those shippers or traded on.

2.20 Therefore, any capacity holdings in excess of intended gas flows by shippers may result in Transco making this unused capacity available to other shippers. This capacity can be interrupted if the shipper who originally purchased the capacity decides to use it or sell it to another shipper who then uses the right.

### *NTS entry capacity buy-back market*

2.21 If Transco is unable to make available firm capacity it has already sold, it must buy-back excess capacity sold at market prices. Under the current arrangements, shippers place offers to sell firm capacity back to Transco on the daily buy back market. In the event of a constraint, Transco will accept offers until it has purchased sufficient excess capacity to alleviate the constraint. Shippers are paid their offer price.

**Transco incentives October 1999 – September 2001**

2.22 Under the Network Code, Transco was liable for 20% of the costs associated with buying back capacity. Transco's exposure under this regime is collared at -£5 million per annum with a monthly collar of £416,000.

2.23 Any costs associated with daily buy-backs of capacity that are not borne by Transco are charged back to all MSEC holders (regardless of the terminal(s) at which they hold capacity rights). Consequently, holders of MSEC bear 80% of the costs of buy-backs up to the level at which Transco reaches its monthly collar. Once this level is reached holders of MSEC bear 100% of these costs.

**Transco incentives from October 2001**

2.24 On 24 August 2001 Ofgem accepted Modification proposal 488, *'Redesign of Capacity Incentive Regime'*. This proposal was raised following Ofgem's acceptance of modification 0481 that provided for the release of increased capacity volumes during the winter 2001/2 MSEC auctions. The release of these additional quantities substantially altered the risk and reward profile under Transco's existing incentive by significantly increasing the probability of buy-back and conversely reducing the probability of daily capacity sales.

2.25 Under the new incentive, Transco is set a target of buy-back costs for the winter months of £60m. Under the scheme, Transco retains a 8.33% proportion of any savings if buy-back costs are below the target and pays a 6.33% proportion if buy-back costs are above the target subject to a monthly cap and collar of £416,000. Transco's annual exposure under the scheme remains at £5m. The new incentive is intended to apply until 31 March 2001.

2.26 Following the implementation of PC65 and 67,[5] Transco established a new 'buy-back fund' methodology for dealing with any over-recoveries of revenue as a result of the monthly auctions. If the auctions yield excess revenue over and above Transco's allowed revenue under the price control, Transco uses the revenue to establish a 'buy-back' fund. The amount of the over-recovery is divided into six monthly amounts. Each month, the fund is used to offset shippers' exposure to any buyback costs not covered under Transco's incentive arrangements. Conversely, if in any month MSEC holders' exposure to the costs of capacity buy-backs exceeds the size of the fund then the remaining costs will continue to be charged back to shippers in proportion to their individual share of MSEC holdings. Any surplus is refunded through adjustments to the general level of transportation charges at the end of the six-month period.

### *Capacity overrun charges*

2.27 One of the key principles underlying the new regime is the 'ticket-to-ride' principle. Overrun charges are applied to shippers that flow gas without acquiring capacity rights. The overrun charges are designed to provide shippers with strong commercial incentives to purchase capacity before flowing gas.

2.28 The current overrun charge is set equal to the higher of:

- 1.1 times the weighted average price by volume of the top 25% accepted bids for daily capacity;
- 1.1 times the highest accepted offer price to sell capacity to Transco; and
- 8 times the daily rate for monthly system entry capacity (based on the weighted average price of the top 50% of bids accepted in the monthly auction).

2.29 The regime ensures that the costs to the system of a participant overrunning are targeted back to that participant.

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[5] PC65, *'Alternative method of funding entry capacity constraint management.'* PC67, *'Technical adjsutment to PC65.'*

### *Summary*

2.30 In this section we outlined the current entry capacity arrangements.

2.31 The current entry capacity regime:

- provides for an efficient and non-discriminatory release and allocation of all available NTS entry capacity through a series of monthly and daily auctions of both firm and interruptible entry capacity products;

- provides Transco with an incentive to ensure that all NTS entry capacity is made available to market and to manage any constraints efficiently;

- provides an effective 'anti-hoarding' mechanism through the release of 'use-it-or-lose-it' interruptible capacity;

- requires Transco to buy-back capacity where it is unable to make physically available firm capacity it has already sold and exposes Transco to a proportion of the costs of any buy back;

- provides financial incentives on Transco to minimise the costs associated with capacity buy-backs; and

- provides strong financial incentives on shippers to purchase entry capacity rights before flowing gas (the 'ticket-to-ride principle') through the use of overrun charges.

# 3. Events in the capacity buy-back market October 2000

### *Introduction*

3.1 In this chapter we set out a description of events in the capacity buy-back market in 2000 and early 2001. We also outline the events of October 2000 that lead to this investigation.

**Capacity buy-back market activity prior to October 2000**

3.2 In March 2000, the auction of monthly firm entry capacity was held for the period of March 2000 to September 2000. The amount of capacity made available in the March auction allowed for a 10% increase over Seasonal Normal Demand (SND).[6] After the first four rounds of the auction, a small percentage (3.4%)[7] of total available capacity was left unsold and was made available in the fifth 'flexible' round. After all rounds, all available capacity was sold with the exception of a very small level of capacity (22 GWh, 0.2% of total MSEC) in April.

3.3 Between April and September 2000, Transco only bought capacity back at the St Fergus entry terminal. In particular, Transco bought back entry capacity on 28 days and on those days purchased back an average of 17.5GWh of capacity. The buy-back activity is summarised in table 3.1.

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[6] Seasonal Normal Demand is the demand that would be expected in a month with average temperatures. Specifically, it is the demand level consistent with the 69 year average temperature for that time of year.
[7] 1.5% of capacity made available at beach terminals was unsold.

**Table 3.1 - Summary of capacity buy-backs prior to October 2000**[8]

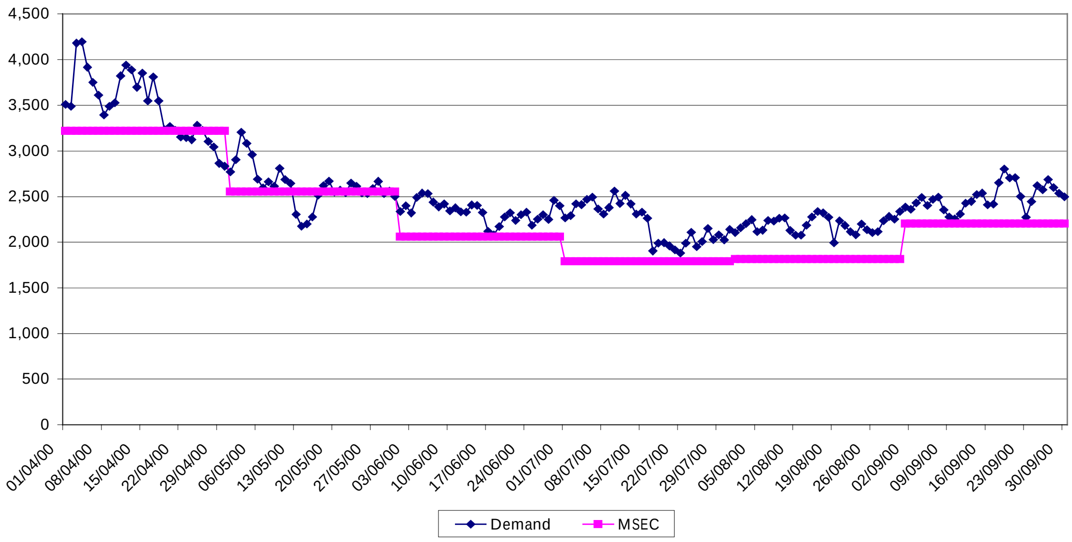
| | Number of Days Requiring Buy-Backs | Average Daily Buy-Back Volume (GWh) | Prices Paid By Transco (p/kWh) | | | Total Cost of Buy-Backs (£) |
|---|---|---|---|---|---|---|
| | | | Weighted Average | High | Low | |
| **April** | 0 | 0 | - | - | - | 0 |
| **May** | 0 | 0 | - | - | - | 0 |
| **June** | 5 | 11.93 | 0.21 | 0.50 | 0.06 | 126,717 |
| **July** | 7 | 28.20 | 0.40 | 0.65 | 0.03 | 783,041 |
| **August** | 10 | 12.57 | 0.07 | 0.12 | 0.05 | 87,259 |
| **September** | 6 | 18.08 | 0.19 | 0.49 | 0.05 | 203,349 |
| **Total** | 28 | 17.54 | 0.24 | 0.65 | 0.03 | 1,200,366 |

3.4 Prices for buy-backs varied during the summer months: the highest weighed average price of 0.40 p/kWh was experienced in July and the lowest weighed average price of 0.07 p/kWh.

3.5 During the summer, demand for entry capacity was high for the summer months. Shippers were exporting significant volumes of gas across the UK-Belgium interconnector to take advantage of higher continental European gas prices. Demand on the system as a whole exceeded capacity released in the monthly auctions for much of the period, as can be seen from Figure 3.1 below. Transco was able to release additional capacity through the daily auctions to meet this additional demand for entry capacity. As a result, the number and volume of buy-back actions was relatively small and focussed exclusively at the St Fergus terminal in Northern Scotland.

[8] All of the capacity buy-backs between July and September 2000 occurred at the St. Fergus terminal.

**Figure 3.1 - MSEC versus System Demand, April to September 2000**




### *Entry capacity buy-back market activity*

**Capacity buy-back market activity October 2000 to February 2001**

3.6 Transco's activity in the capacity buy-back market during the period October 2000 to February 2001 is summarised in table 3.2.

**Table 3.2 – Summary of capacity buy-backs October 2000-February 2001[9]**

| | Number of Days Requiring Buy-Backs | Average Daily Buy-Back Volume (GWh) | Prices Paid By Transco (p/kWh) | | | Total Cost of Buy-Backs (£) |
|---|---|---|---|---|---|---|
| | | | Weighted Average | High | Low | |
| **October** | 20 | 76.71 | 0.55 | 1.54 | 0.0031 | 8,514,192 |
| **November** | 8 | 47.78 | 0.45 | 0.75 | 0.02 | 1,723,850 |
| **December** | 5 | 28.63 | 0.61 | 1.75 | 0.09 | 869,433 |
| **January 2001** | 0 | 0 | - | - | - | 0 |
| **February** | 1 | 128.53 | 0.37 | 0.50 | 0.34 | 475,158 |
| **Total** | 34 | 64.35 | 0.53 | 1.75 | 0.0031 | 11,582,633 |

[9] In October 2000, 94% of the capacity buy-backs occurred at St. Fergus with the remaining 6% taking place at Teesside. All of the subsequent capacity buy-backs between November 2000 and February 2001 occurred at the St. Fergus terminal.

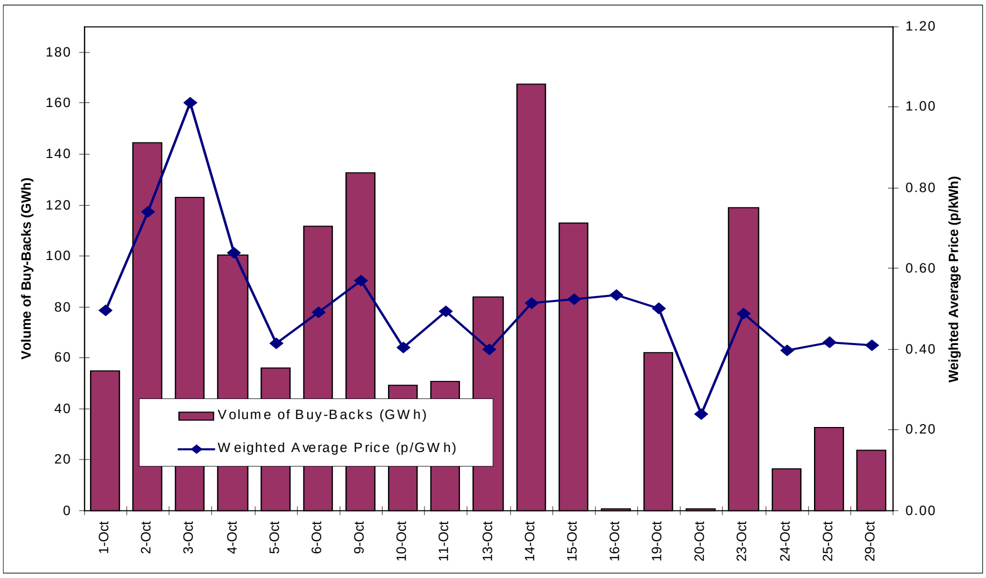
3.7 In October 2000, Transco's activity on the buy-back market reached its peak. In particular, the number of active days and the total buy-back costs were higher than those experienced in either previous or subsequent months. Transco bought back substantial amounts of capacity also in December and November 2000. The amount of capacity purchased and the costs incurred by Transco during these months are considerably higher than those experienced in the summer months.

3.8 Transco's buy-back activity significantly decreased after December 2000, with buy-backs occurring on only one day in the first two months of 2001. Prices at St. Fergus between November 2000 and February 2001 ranged from a minimum of 0.0031 p/kWh to a maximum of 1.7499 p/kWh, with an average price of 0.4634 p/kWh.

*October 2000 entry capacity buy-back market - volumes*

3.9 In Figure 3.2 we illustrate the volumes and the weighted average prices of entry capacity bought back by Transco on each day in October 2000.

**Figure 3.2 - Volumes of buy-backs and average prices paid by Transco at St Fergus (only constrained days shown)**




3.10 Buy-backs occurred on each of the first six days in October and on 20 days in total. Buy-back volumes were predominantly concentrated in the first half of the month and peaked in the middle of October. The majority of this capacity

(94%) was purchased at St. Fergus. In addition, Transco bought back capacity at Teesside on four days in October as an alternative to buying capacity at St. Fergus.

*October 2000 entry capacity buy-back market - prices*

3.11 The unit cost of these buy-backs peaked on 3 October 2000 at about 1.54p/kWh and then decreased to around 0.55p/kWh. At St. Fergus, prices spiked at the very beginning of October and became less volatile thereafter.

3.12 During the month of October, the prices of offers to sell capacity accepted by Transco at St. Fergus ranged from a minimum of 0.0128 p/kWh to a maximum of 1.5354 p/kWh, with an average price of 0.5775 p/kWh.[10] The combination of buying back large volumes of capacity at high prices meant that Transco reached its maximum monthly exposure (the £416,000 cap) under the capacity incentive scheme within three days.

*The reasons for Transco buy-backs in October 2000*

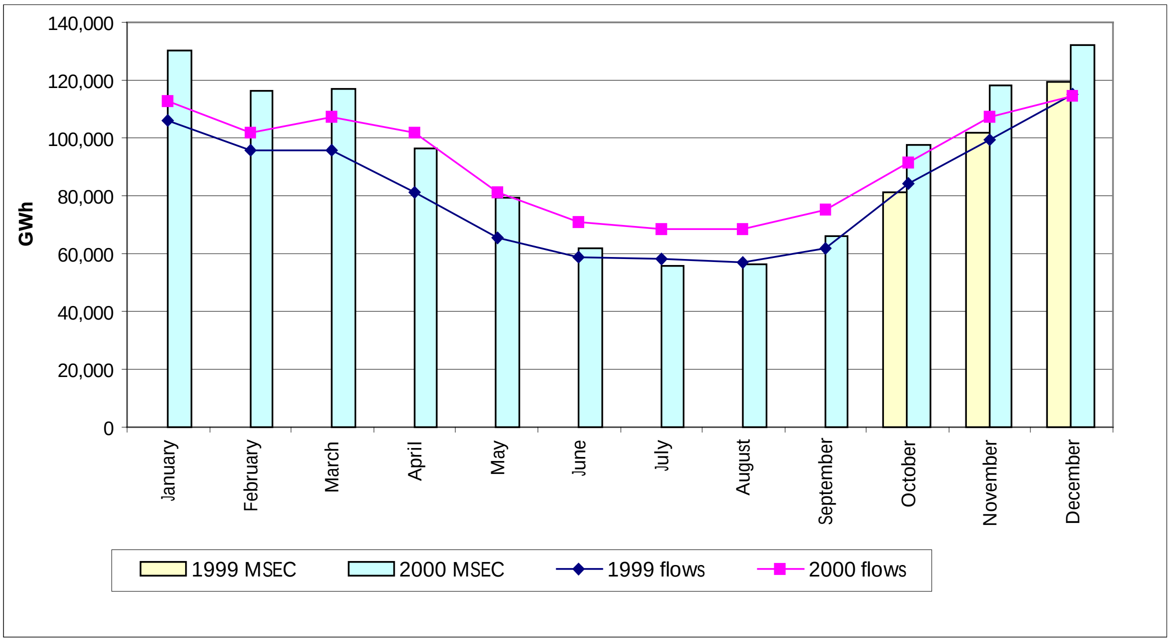
3.13 Warmer than average weather in October led to lower GB gas demand. As a result, Transco faced constraints in the volume of gas it could evacuate from Northern terminals (such as St Fergus) to meet demand that was predominantly located in the South of the country. Shippers wanted to flow more gas through the St Fergus terminal to meet demand than Transco was able to accommodate. As a result, Transco was unable to evacuate all of the gas that shippers nominated to flow against their firm capacity rights at the St. Fergus entry terminal.

3.14 As shown in Figure 3.3, the volume of MSEC made available by Transco in October, November and December 2000 was higher than that provided in the same months in 1999. The greater availability of capacity was the result of Modification 380, which required Transco to release an additional 10% of capacity by calculating the volumes of capacity made available in the monthly auctions on the basis of SND plus 10%.

[10] At Teesside prices ranged from a minimum of 0.3409 p/kWh to a maximum of 0.5274 p/kWh, with an average price of 0.3961 p/kWh.

3.15 The gas flows in 2000 were also higher when compared to the previous year, with October 2000 showing a 9% increase over the same period in 1999.

**Figure 3.3 - 1999-2000 Gas Flows and available MSEC by month**




3.16 The volume of gas transported through the NTS in October tends to vary considerably within-month due to weather changes that typically occur in this month. As shown in Figure 3.4 and 3.5, daily temperatures tend to fall during the month and these large potential differences between daily gas flow rates mean that a release of firm capacity on a monthly average basis will result in periods where capacity is either over or under sold.

**Figure 3.4 - Actual Temperature and Seasonal Normal Temperature (SNT) in October**

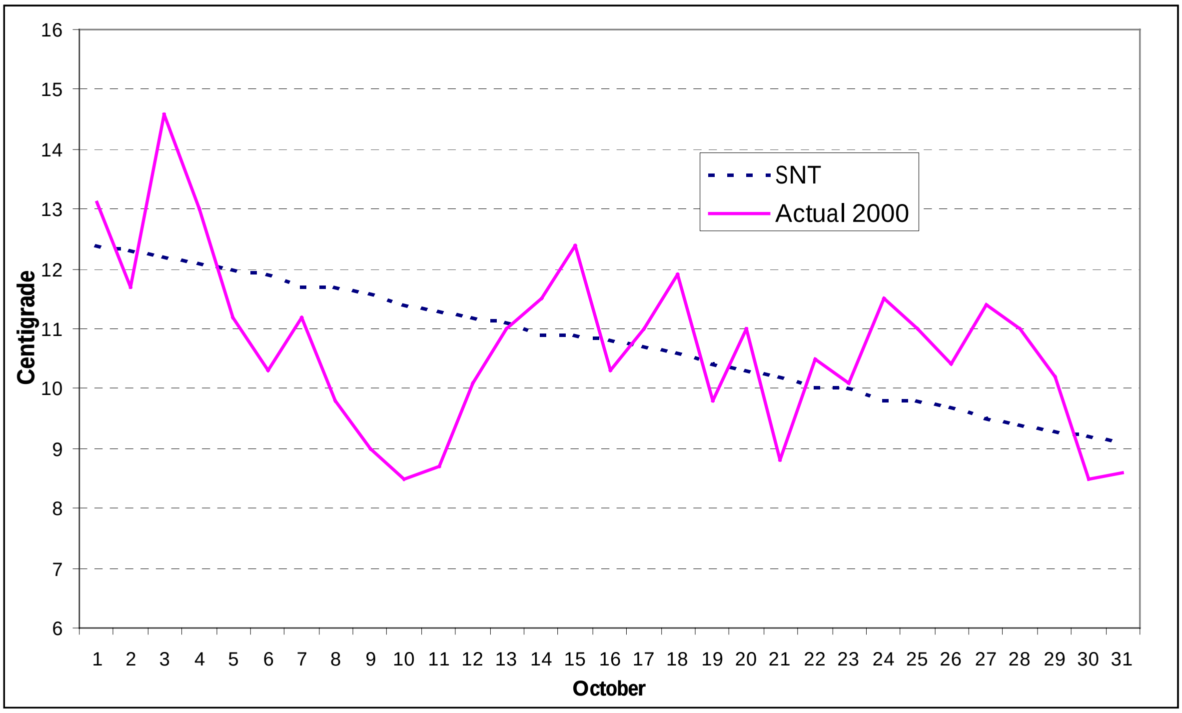
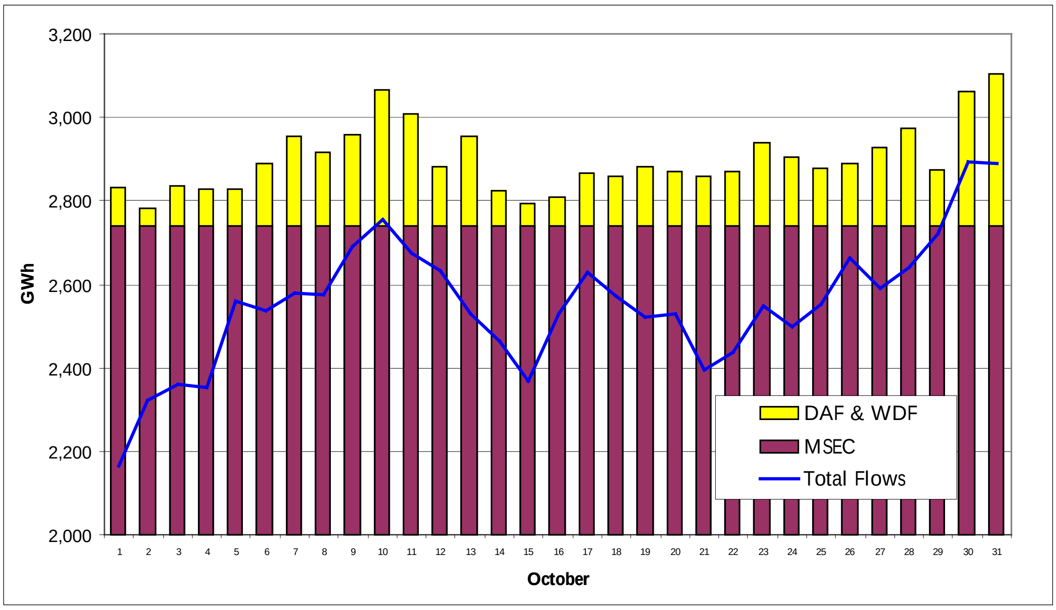



**Figure 3.5 - Firm capacity released monthly (MSEC), day-ahead (DAF) and within-day (WDF), and Actual Gas Flows at the five major terminals[11] in October**




3.17 The 'shoulder' characteristics of MSEC were particularly pronounced at St. Fergus in October 2000 given the volumes of capacity sold at that terminal by Transco. In the auction for October 2000 to March 2001 MSEC, about 6.6% of total available capacity was left unsold at the end of round four at a number of

[11] These terminals includes St. Fergus, Teesside, Theddlethorpe, Bacton and Easington.

terminals. However, almost all the available capacity at St. Fergus in October was sold in the first four rounds and in the fifth round, Transco allocated a further 96 GWh/day to the St. Fergus terminal in October (equivalent to 8% of the capacity sold at St. Fergus in the first four rounds).[12] As a result, the level of MSEC sold in October 2000 was 27% higher than that sold in the previous year.

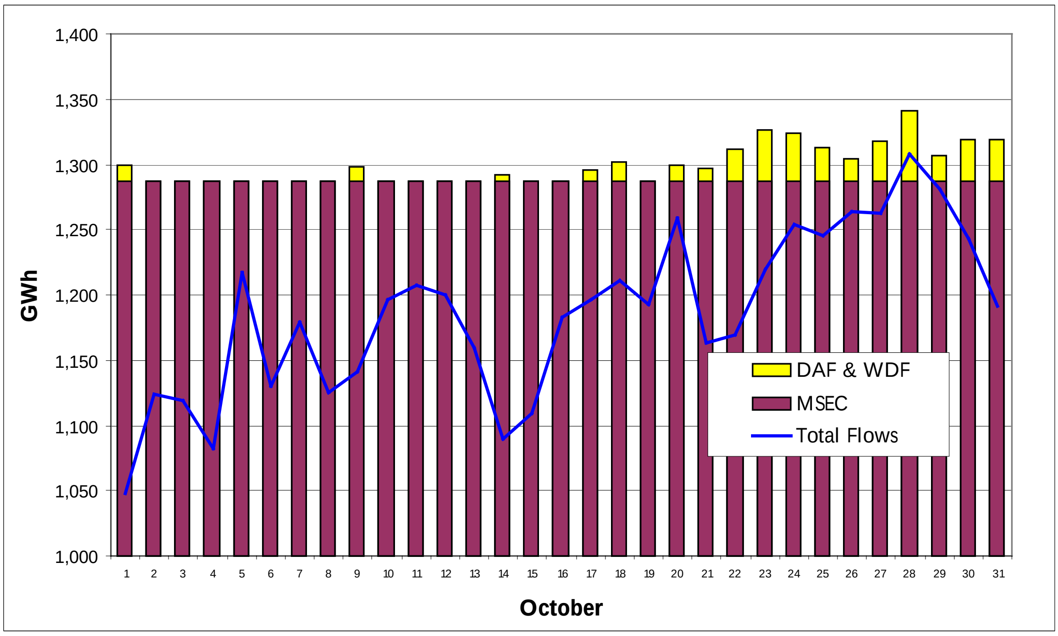
3.18 As a consequence of the relatively low levels of demand in comparison to the released capacity, Transco was unable to evacuate all of the gas that shippers had nominated to bring in at St Fergus (see Figure 3.6). Transco was then required to buy-back a portion of the firm capacity it had sold and was unable to provide by shippers.

3.19 Although system demand was lower than average overall, shippers clearly wanted to continue to maintain flows at St Fergus to meet demand in preference to landing gas at other entry points. As a significant proportion of gas landed at St Fergus is produced in association with oil, the opportunity costs of curtailing oil production (in terms of lost profit) to reduce gas flows could be significant. Therefore, during periods of relatively low demand, producers are likely to want to land gas from associated gas fields in preference to gas from dry gas fields. This can give rise to constraints at particular entry points on the NTS even if there is more than enough capacity in aggregate to meet demand.

3.20 In October, Transco bought back capacity at Teesside on four days. Since events last year, Transco has indicated, as part of its Transporting Britains' Energy consultation process,[13] that NTS constraints are predominantly associated with North-South flows. Transco has indicated that the amount of gas that can be evacuated through St Fergus depends, at least in part, on flows at the Barrow and Teeside terminals. Transco has indicated that reducing flows at Barrow and/or Teeside would increase capacity availability at St Fergus although the relationship between the capacity availability at the three terminals is complex.

[12] In addition, the amount of capacity made available at St. Fergus in the first 4 rounds was 10% higher than that sold in the MSEC auction for October 1999 as a result of Modification 380.
[13] http://www.transco.uk.com/

**Figure 3.6 - Firm capacity released monthly (MSEC), day-ahead (DAF) and within-day (WDF), and Actual Gas Flows at St. Fergus in October**




### *Initiation of shipper buy-back market behaviour investigation*

3.21 The total cost of capacity buy-backs in October 2000 exceeded £8.5 million with 97% of buy-backs occurring at the St Fergus entry terminal. As a result of the high costs of buying back this capacity and the large spread of capacity prices offered by shippers to Transco, Ofgem wrote to all shippers expressing its concern about the high prices offered by some shippers in the buy-back market. This letter was issued on 17 October 2000 and is reproduced in Appendix 2.

3.22 In the light of our concerns, on 23 October 2000, Ofgem issued a general shipper information request. This request required shippers to provide information regarding the volumes, prices, locations and the names of counter parties for all trades of monthly firm capacity which were for delivery between 1 October and 23 October 2000.

**Shipper entry capacity overrun behaviour**

3.23 In addition to the investigation of shippers' trades in the entry capacity buy-back market in October 2000, Ofgem also analysed shippers' overruns of entry capacity holdings.

3.24 In our investigation, Ofgem analysed data on overruns between July 2000 and October 2000. The results of this investigation are outlined in detail in Chapter six.

**Initial analysis of shipper behaviour in the capacity buy-back market**

3.25 Following the receipt of responses to the information request of 23 October 2000, Ofgem commenced an initial comparative analysis of pricing in the buy-back and secondary capacity markets.

3.26 The initial analysis looked at the pricing behaviour of shippers who both traded monthly firm capacity with other shippers on the secondary market and/or sold back monthly firm capacity to Transco from 1 October 2000 to 23 October 2000. The analysis covered the behaviour of the 21 shippers who traded entry capacity at St. Fergus and of the 14 shippers who traded at Teesside during the applicable weeks.

3.27 The analysis compared prices charged to Transco when it bought back capacity against prices prevailing in shipper-to-shipper trades, in order to assess whether there was any evidence of anti-competitive behaviour (such as undue price discrimination). The analysis was performed both at an aggregate and an individual shipper level.

3.28 The analysis also evaluated the prices charged to Transco, net of the proportion of total constraint costs that are allocated to shippers at an aggregate and individual shipper level. In doing so, Ofgem sought to compare net buy-back prices to prices of trades in the secondary market. Finding that net buy-back prices have been substantially higher than secondary market prices could be seen as prima facie evidence that shippers have been factoring up their bids in the buy-back market in an attempt to mitigate their exposure to the smear back of constraint costs.

*Aggregate Analysis of Shipper behaviour – Gross Weighted Average Price*

3.29 At St. Fergus, in the period between 1 October and 23 October 2000, 1939 GWh of capacity was traded both among shippers on the secondary market and between shippers and Transco. At Teesside, between 1 October and 23 October 2000, 383 GWh of capacity was traded among shippers on the secondary market and between shippers and Transco. Of the total capacity traded, Transco purchased 73% of that at St. Fergus and 23% of that at Teesside.

3.30 Figures 3.7 and 3.8 show the aggregate daily weighted average price (WAP) of capacity sold to the shippers and to Transco at St. Fergus and Teesside respectively. The two figures provide preliminary evidence that, at an aggregate level, Transco generally paid a higher price for capacity than that paid by shippers buying firm monthly capacity on the secondary market. The average premium paid by Transco was 0.2013 p/kWh at St. Fergus and 0.3173 p/kWh at Teesside.

3.31 As an alternative to purchasing St. Fergus capacity, Transco bought back capacity at Teesside on a small number (four) of days. Figure 3.7 shows a decrease in the price paid by Transco at St. Fergus on 10 October 2000, the day after Transco's buy-backs at Teesside had started.

**Figure 3.7 - Weighted average price of capacity sold to Transco and to shippers at St Fergus, October 2000**

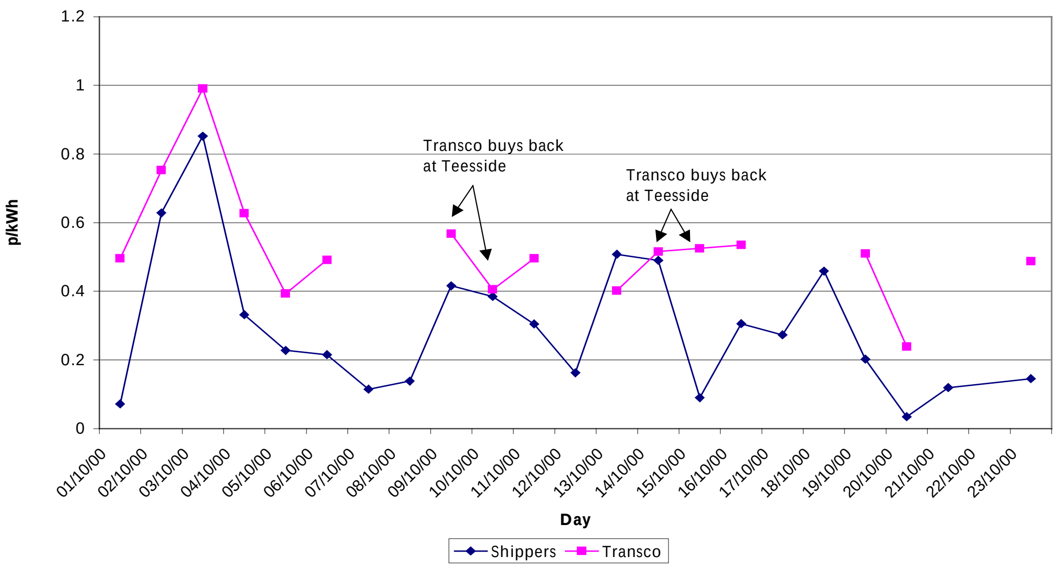
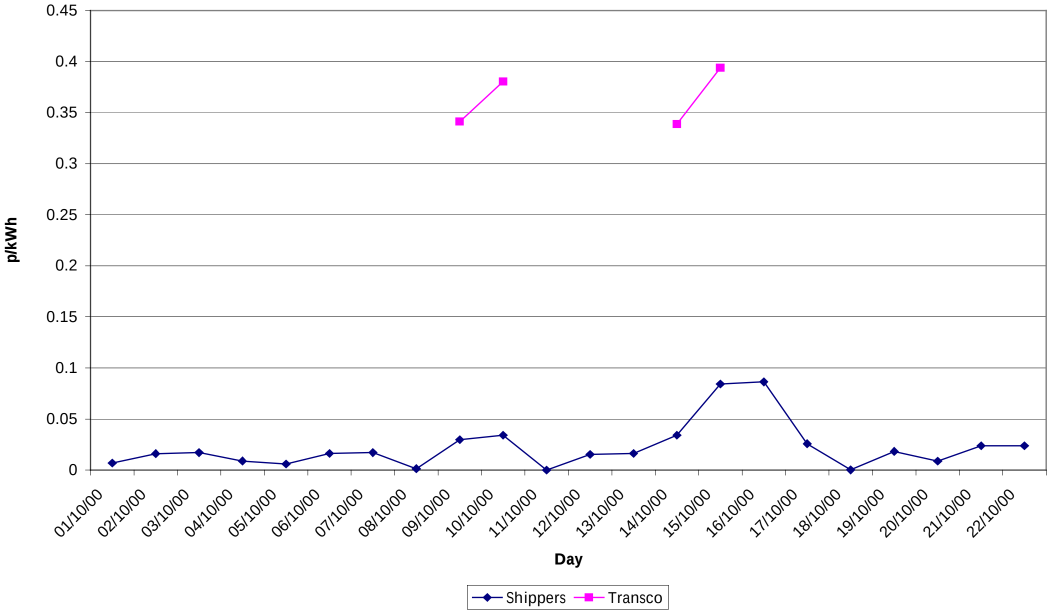


**Figure 3.8 - Weighted average price of capacity sold to Transco and to shippers at Teesside, October 2000**




*Aggregate Analysis of Shipper behaviour – Net Weighted Average Prices*

3.32 Figures 3.9 and 3.10 show the weighted average price for capacity net of the portion of buy-back costs ultimately paid by the shippers. The results for St. Fergus significantly change, as the net price paid by Transco for capacity is generally lower than the one employed in shipper-to shipper trades. By contrast, at Teesside, the net price paid by Transco remains considerably higher than the one prevailing on the secondary market. The average net premium paid by Transco was 0.2184 p/kWh at Teesside, whilst at St. Fergus Transco received a net discount of 0.0955 p/kWh.

**Figure 3.9 - Net WAP of capacity sold to Transco and WAP of capacity sold to shippers at St Fergus, October 2000**

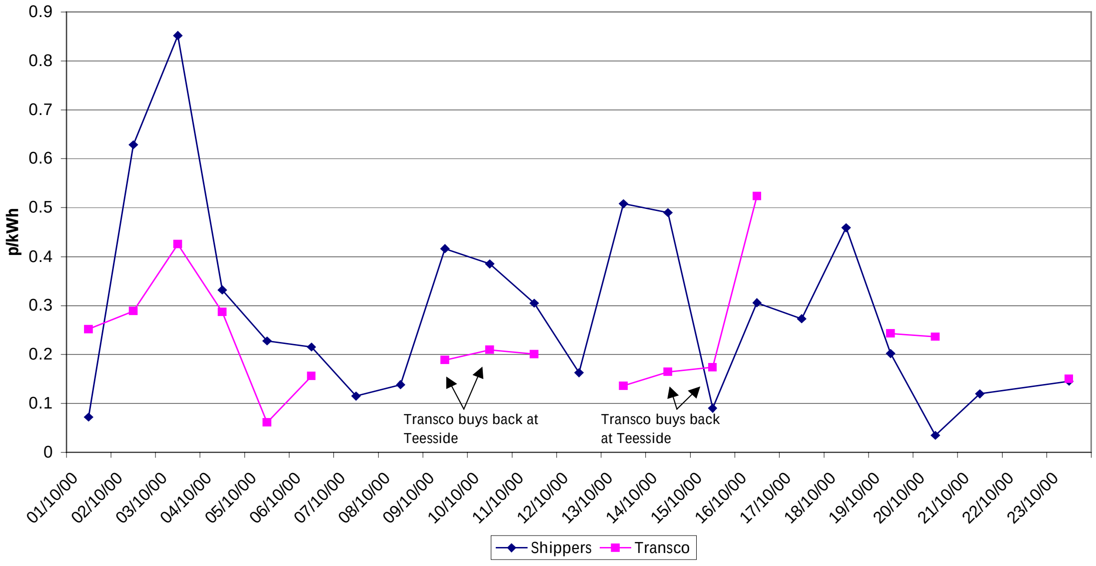
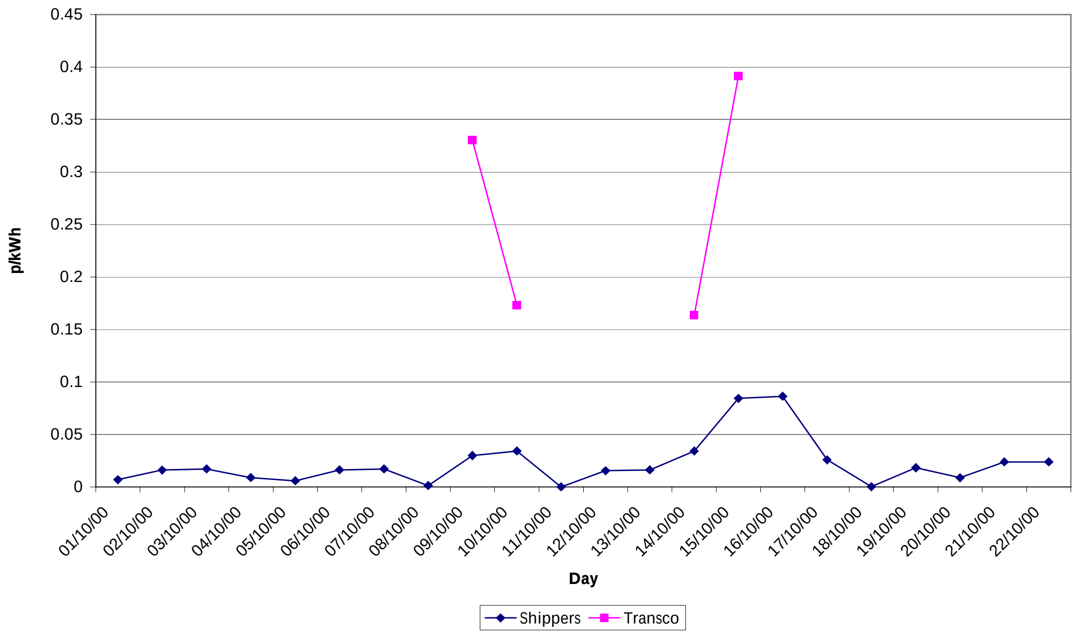



**Figure 3.10 - Net WAP of capacity sold to Transco and WAP of capacity sold to shippers at Teesside, October 2000**



## Conclusions

3.33 Ofgem's initial analysis suggested that:

- shippers appeared to have factored up their bid prices to Transco at both St Fergus and Teesside and were selling capacity back to Transco at higher prices than those prevailing in the secondary markets. Indeed at St Fergus, all shippers who traded both with Transco and with other shippers sold capacity to Transco at a premium;

- at an aggregate level, there was no conclusive evidence that shippers at St. Fergus were factoring up their bids in the buy-back market to take account of the smear back of that proportion of Transco's buy back costs not covered by Transco's incentives;

- at Teesside, Transco paid a substantial premium to buy-back capacity relative to the prices at which shippers were trading the same capacity between themselves.;

- Transco bought back capacity at the St Fergus terminal at a price net of the smeared back costs that was generally lower than the price paid by shippers to buy capacity on the secondary market. Therefore, at an aggregate level, it seems that shippers at St. Fergus have not been factoring up their bids to mitigate the smear-back of costs; and

- prices for capacity buy-backs at Teesside have converged to some extent with the prices of capacity buy-backs at St Fergus. This suggested that Transco and shippers viewed Teeside and St Fergus capacity as very close substitutes when seeking to alleviate constraints through the buyback market.

3.34 A detailed summary of Ofgem's analysis of individual shipper behaviour is set out in Chapter 4.

# 4. Shippers' capacity market activities in October 2000

### *Introduction*

4.1 In the previous chapter, we have explained that the analysis of prices in the buy-back and secondary capacity markets in October 2000 raised concerns that some shippers may have engaged in a form of price discrimination. This pricing behaviour may have increased Transco's costs of buying back capacity.

4.2 In this chapter we report the details of the trades undertaken by the five shippers who were required by Ofgem to provide further explanation of their pricing behaviour in the buy-back and secondary capacity market. The five shippers were Amerada, British Gas Trading, Enron, Powergen and TotalFinaElf ("the shippers"). We outline below the activity of each shipper in the capacity market, Ofgem's initial views, the companies' responses to Ofgem's concerns and our conclusions.

4.3 Based on the data and information supplied to Ofgem by these shippers, we found no evidence of behaviour warranting further investigation and/or action.

### *Individual shippers behaviour*

4.4 Ofgem has explored the pricing behaviour of individual shippers to determine:

- ♦ whether individual shippers were selling capacity back to Transco at premium relative to shipper-to-shipper trades; and
- ♦ whether individual shippers may have been pricing to mitigate the effects of the smear back in response to the prices set by one or two of the larger potentially dominant shippers in the buy-back market.

4.5 In order to undertake this analysis Ofgem identified a number of shippers, each with a significant share of the buy-back market either at St. Fergus or Teesside between 1 and 23 October 2000 and analysed their pricing behaviour.

4.6 Ofgem concluded from its analysis that the data available provided sufficient grounds to require some of these shippers to explain their behaviour in the buy-back market. In particular, Ofgem found that during the month of October some shippers might have adopted a strategy of offering capacity to other shippers and Transco at materially different prices.

4.7 If there was evidence of sustained price discrimination, this could have provided some evidence of potentially anti-competitive conduct. In a competitive market and in the absence of any market power, any sustained difference between prices in the secondary market between shippers and the price of buy backs would be arbitraged. Shippers and traders could purchase capacity in the secondary market and sell it back to Transco at a profit.

4.8 The shippers, who were asked to provide a more detailed explanation of their conduct following our initial analysis were:

- British Gas Trading;
- Total Fina Elf;
- Amerada;
- Enron; and
- Powergen.

4.9 In Table 4.1, we report these shippers' share of capacity sold to Transco in October 2000 and the average premium at which they sold capacity to Transco relative to shipper-shipper trades.

**Table 4.1 - Individual shipper behaviour in the entry capacity market, October 2000**

| **Shipper** | **% of capacity sold to Transco at St. Fergus** | **Premium (%) Transco trades over shipper trades** |
|---|---|---|
| Amerada | 14.6% | 214% |
| British Gas Trading | 45.2% | 477% |
| Powergen | 7.6% | --- |
| TotalFinaElf | 10.8% | 242% |
| All trades | - | 173% |
| | *% of capacity sold to Transco at Teesside* | |
| Enron | 55.8% | 1106% |
| All trades | - | 1555% |

4.10 This table provides evidence that these shippers had traded with Transco at prices significantly above those at which they were prepared to trade with other shippers. On the basis of this evidence, Ofgem looked at a number of individual days to try and identify any days where shipper-Transco and shipper-shipper trades were undertaken by each shipper at significantly different prices on the same day.

4.11 For each of the shipper's identified above (with the exception of Powergen), Ofgem found evidence of particular days when the shippers transacted both with other shippers and with Transco at significantly different prices. Table 4.2 reports the days on which each shipper conducted capacity trades with Transco and with other shippers and the average premium paid by Transco over and above secondary market prices.

**Table 4.2 - Examples of price of shipper-Transco and shipper-shipper trades for individual shippers[14]**

| Date | Shipper | Terminal | Transco premium (%) |
|---|---|---|---|
| 05/10/00 | Amerada | St. Fergus | 32% |
| 23/10/00[15] | Amerada | St. Fergus | 305% |
| 01/10/00 | BGT | St Fergus | 705% |
| 03/10/00 | BGT | St Fergus | 856% |
| 9/10/00 | Enron | Teesside | 1011% |
| 10/10/00 | Enron | Teesside | 1049% |
| 14/10/00 | Enron | Teesside | 1135% |
| 15/10/00 | Enron | Teesside | 76% |
| 02/10/00 | TFE | St. Fergus | 365% |
| 23/10/00 | TFE | St Fergus | 335% |

4.12 On the basis of this analysis, Ofgem considered that there was some prima facie evidence of potential price discrimination by four of the five shippers. Powergen had not, during the period under investigation, traded with other shippers and had only sold back to Transco.

4.13 Ofgem wrote to the above shippers on 22 February 2001 to provide them with an opportunity to present evidence to Ofgem to explain their behaviour. Following these letters several meetings and, in some cases, exchanges of correspondence occurred between Ofgem and the shippers that were requested to explain their behaviour.

4.14 In these letters, Ofgem explicitly recognised a potentially benign explanation for any difference in prices between sales of capacity to Transco and sales to other shippers could be the result of trading at different times of the day.

[14] The prices that appear in this table are weighted average prices.
[15] Ofgem was subsequently informed by Amerada that this trade was reported in error. See below.

4.15 In particular, Ofgem made clear in the letters it sent to shippers that any differences in the prices between trades undertaken with Transco and trades undertaken with other shippers could be explained by differences in market conditions during the gas day. Therefore, the opportunity cost of forgoing capacity and the price bid on the buy-back and secondary markets could have been different at different times within the same day.

4.16 In this respect, a number of companies expressed their concern about the usefulness of Ofgem's information request of 23 October 2000, as it did not seek any data on the exact time of trades. However, it was Ofgem's intention to reduce the amount of data requested at this stage from all shippers. On the basis of our preliminary analysis (based on the information obtained) we were able to eliminate a number of shippers. More detailed information was only required from a handful of shippers as a result.

4.17 A number of companies also suggested that Ofgem should have requested information on shipper-to-shipper trades and the times of these trades from Transco. Ofgem did request the same information from Transco so that shippers' individual responses could be validated. This allowed us to be certain that all trades had been included in their responses by shippers. Ofgem did not ask Transco to provide information on the timing of shipper-to-shipper trades as shippers frequently notify these trades some time after they are completed. Transco only logs the time that the trade is notified and this does not necessarily reflect the time that the trade was made.

### *Shippers responses*

4.18 Each of the shippers responded to Ofgem's letters by providing an explanation of their behaviour in the buy-back market. The arguments shippers presented included:

- The timing of capacity trades
  The price differentials reflected changing market conditions within the day as shipper-to-shipper trades were traded in different periods of the day to the Transco-shipper trades.

- Market power

  Shippers argued that their capacity holding and participation in the secondary markets and buy-back markets were too small to influence prices. Shippers argued that they simply traded at prevailing market prices where these prices allowed them to make a margin.

- The importance of price competition

  Shipper's pricing decisions are determined more by price competition with other shippers (and therefore the prevailing price in the market) rather than actively factoring the proportion of buy-back costs that they might bear.

- The nature of the buy-back market

  Transco buys capacity out of necessity (due to a physical constraint) and there is no reason to believe that shippers seeking capacity on the market are buying under the same demand conditions;

- Limited gas supply contractual flexibility

  Shippers argued that the opportunity costs (reflected in prices) of releasing capacity could be very high, particularly where gas supply contracts are take-or-pay.

- Failure on Transco's part

  Transco's actions and use of the buy back market led to higher prices than might have been the case if Transco had adopted a more sophisticated strategy. Transco frequently bought large volumes at very short notice and this could prevent competitive re-pricing in the buy-back market.

4.19 In the sections below, we discuss each individual shipper's response and Ofgem's views with regard to that response. Ofgem's general conclusions arising from its investigation follows the discussion of the behaviour of each shipper.

### Amerada

4.20 In its letter to Amerada of 22 February Ofgem identified two days in which Amerada traded with Transco and other shippers at materially different prices, namely 5 and 23 October 2000.

4.21 Ofgem was subsequently informed by Amerada that the shipper to shipper trade that occurred on 23 October was reported in error in Amerada's response to Ofgem's information request.

*Amerada's response*

4.22 Amerada responded that with regard to its behaviour in the buy-back market, the different prices charged to Transco and to its other counter parties in October 2000 reflected the different times of trades and the market conditions prevailing at the time.

4.23 Amerada explained that on 5 October one of its trades with Transco occurred during normal working hours whilst the other, higher priced, trade occurred out of hours (shortly before midnight). Further, Amerada's shipper to shipper trade took place during normal business hours and reflected the prices prevailing in the shipper-shipper market at that time.

4.24 In this context Amerada indicated that the differences between prices could be explained by a number of factors. In particular Amerada indicated that:

- the cost of selling capacity back to Transco later in the day tends to be higher as the commercial risks of failing to buy gas on the market increases towards the end of the day;

- the cost of selling capacity back to Transco will be influenced by the differential between the cost of buying gas on the day and the value Amerada would receive for it when it is produced at some point in the future; and

- liquidity in the secondary capacity market may be reduced during out-of-hours periods with few shippers being adequately equipped for 24 hour trading and shippers being reluctant to curtail production late at night and at short notice.

4.25 Amerada stated that it does not incorporate the effect of smear-back when pricing offers to sell capacity.

4.26 Amerada also argued that it had a small share of the capacity market and was in no position to influence prices in the capacity market.

*Ofgem's conclusions*

4.27 Ofgem considers that the evidence provided to Ofgem by Amerada supports the position that the trade it undertook with Transco during normal business hours occurred at a time when market conditions were similar to those prevailing in the trade it undertook with the other shipper. By contrast the second trade with Transco occurred later in the day when market conditions and the opportunity costs of releasing capacity had changed.

4.28 Ofgem accepted Amerada's explanation that the higher priced trade to Transco that occurred late on 5 October reflected market conditions and the opportunity costs of forgoing capacity that differed from those prevailing earlier in the day.

4.29 Ofgem therefore has concluded that Amerada's explanation of its pricing behaviour in the buy-back market is sufficient and no further investigation was required.

**British Gas Trading**

4.30 In its letter of 22 February, Ofgem identified two days on which BGT traded with Transco and shippers at materially different prices, namely 1 and 3 October 2000.

*BGT's response*

4.31 BGT responded that it traded with Transco and with other shippers at different times. The trades with other shippers occurred between 11.30 pm and 1.30 am, close to the end of the gas day, and therefore reflected sales of excess capacity. However, the trades with Transco occurred shortly after the gas day had commenced and were not sales of surplus capacity.[16] Consequently, BGT stated that it priced this capacity to reflect the different value placed on the rights.

4.32 BGT stated it does not attempt to set the capacity price but instead seeks to compete with other shippers in offering capacity to Transco in the buy back market. For instance, on 3 October 2000, BGT had a high price offer accepted by Transco. This high priced offer was originally placed on the capacity buy-back market late on 2 October to match another shippers offer. However, BGT failed to notice that the other shipper's offer was subsequently withdrawn.

4.33 BGT also disputed its ability to exert market power in the buy-back market, noting that to attract offers to the buy-back market, a margin must exist over the purchased price of capacity which should be eroded in time by competition. High prices on a given day could not be construed to be evidence of abuse of market power. BGT argued that only long-term excessive pricing above opportunity costs for a sustained period could be taken as an indicator of market abuse and/or anti-competitive behaviour. In this respect, BGT noted that high prices observed at the beginning of October fell away towards the end of the month, indicating a properly functioning market, with shippers bidding the margins away.

4.34 In relation to the issue of considering the smear back when making offers to sell capacity back to Transco, BGT stated that the size of the aggregate smear-back on a day depends in part on Transco behaviour in accepting offers, and in part on the offer strategy of shippers. The proportion of the aggregate smear-back to which a shipper is exposed depends on its capacity holdings. BGT went on to state that a shipper will tend to reduce its buy-back offers, in competition with others, until such time as its offers approach the level of its opportunity costs. By doing so, it improves the prospects of its offers being accepted by Transco and, in this way, can reduce the aggregate smear-back and its own exposure to the smear-back.

[16] In particular, on the gas day 1 October 2000, the inter-shipper trade occurred at 1:28 of 2 October 2000 for the gas day of 1 October, while the trades with Transco took place at 10:26 and 12:12. On 3 October 2000, the inter-shipper trade occurred at 23:47, whilst the trade with Transco took place at 08:00.

4.35 BGT stated that its own offer strategy was framed with this relationship in mind.

4.36 BGT also remarked that in the early days of the buy-back market when its two more extreme trades occurred, few or no offers were posted in competition. In general, Transco had to post messages soliciting the market to place offers at times when it required to buy-back capacity. BGT was not aware of the reasons for such a lack of competition.

4.37 BGT also commented that Transco's buy back process may not have generated the most cost effective outcome. In particular, BGT noted that Transco often accepted large volumes of capacity offers at the same time, rather than accepting offers on an incremental basis, thereby reducing shippers opportunities to competitively re-price.

*Ofgem's Conclusions*

4.38 Ofgem have concluded that BGT's explanation of pricing behaviour in the buy-back market is sufficient and no further investigation is required.

4.39 Ofgem believes that the evidence and analysis presented by BGT provides an adequate explanation of the pattern of pricing behaviour. Ofgem considers that the evidence provided by BGT supports the position that the trades with Transco occurred at the beginning of the gas day whilst trades with other counter-parties occurred significantly later in the day at a time when the capacity was surplus to BGT's requirements.

4.40 Therefore Ofgem accepted BGT's explanation that the higher price offered to Transco reflected market conditions and the opportunity costs of forgoing capacity that differed from those prevailing in the trades with shippers.

**Enron**

4.41 In its letter of 22 February 2001 Ofgem identified four days on which Enron traded both with Transco and other shippers at Teesside at materially different prices. On each occasion the price charged to Transco was significantly higher than the price applied to other shippers.

*Enron's response*

4.42 With respect to its behaviour in the capacity market, Enron stated that it does not engage in price discrimination. Enron indicated that it simply sells capacity to the party that is willing to pay the highest price.

4.43 In responding to Ofgem's concerns, Enron provided details of the times at which it traded with both Transco and other shippers. This data indicated that the times at which Enron traded with Transco were materially different from the times at which it traded with other shippers and generally occurred earlier in the gas day.

4.44 Enron argued that the higher prices charged to Transco on the occasions identified by Ofgem merely reflected the market conditions and the opportunity costs of forgoing capacity that differed from those prevailing in the trades with other shippers.

4.45 Enron argued that the differences between prices could be explained by a number of factors. In particular Enron argued that:

- the opportunity cost of releasing capacity to the market tends to fall during the gas day, reflecting the fact that the uncertainty over actual gas flows decreases as the day progresses. As such, towards the end of the gas day Enron will be in a better position to ascertain whether they will have any surplus of capacity rights. Therefore, trades with Transco early in the gas day will tend to be priced higher than trades towards the end of the gas day; these later trades being sales of rights which Enron is unlikely to exercise;

- Enron could not be considered to have market power at either St Fergus or Teesside based on the percentage of entry capacity held at these terminals; and

- the prices of Enron's transactions at Teesside reflected those prevailing at St Fergus due to the interdependence of the two capacity markets.

*Ofgem's conclusions*

4.46 Ofgem have concluded that Enron's explanation of pricing behaviour in the buy-back market is sufficient and no further investigation is required.

4.47 Ofgem believes that the evidence and analysis presented by Enron provides an adequate explanation of the pattern of pricing behaviour. It is reasonable to expect that the opportunity cost of selling surplus capacity at the end of the gas day is substantially lower than that of forgoing capacity during the day when there is uncertainty regarding the final gas flow position. The differential in prices for capacity sold to Transco and to other shippers can therefore be a reflection of the timing of the respective trades.

**Powergen**

4.48 In its letter of 22 February 2001 Ofgem identified eight occasions on which Powergen sold capacity at prices that were significantly higher than the daily weighted average prices prevailing in shipper-to-shipper trades on the secondary market. As outlined above, Powergen did not trade with other shippers during the relevant period in October.

*Powergen's response*

4.49 Powergen has indicated that it is predominantly a physical participant in the capacity market and simply attempts to secure the capacity it needs in the monthly auctions to optimise its position with respect to its gas supply contract and generation requirements. As such Powergen has indicated that it has limited capacity to trade in secondary markets. Further, in this context Powergen argued that it is not recognised within industry as a capacity trader and as such, is rarely approached for spare capacity. Powergen explained that as it did not trade (or refuse to trade) with other shippers during the relevant period in October the only market prices visible to Powergen were those paid by Transco in the buy back market. Powergen also indicated that it was not aware of the quantities and prices traded in the secondary market.

4.50 Powergen explained that there are significant opportunity costs associated with releasing capacity back to Transco in the buy-back market during October 2000 as it is the beginning of the gas year. In particular, Powergen has stated that at the beginning of the gas year there is a strong incentive to maximise flows under take or pay contracts as early as possible to hedge against the risk that contract volumes cannot be taken by the end of the contract year.

4.51 In addition, selling capacity back to Transco may require Powergen to purchase NBP gas during colder periods thus reducing the value of its take or pay contract.

4.52 Powergen indicated that it is not dominant at St. Fergus as it has only a limited share of annual gas flows at St. Fergus. Powergen considers that its small share of the market coupled with its strict contractual and physical requirements significantly limits its willingness and ability to trade capacity.

4.53 Powergen also argued that the high buy-back prices paid by Transco in October might have been the consequence of the current buy-back market. In particular, it contended that the first real use of the buy-back mechanism coincided with the start of the new gas year. This is likely to have involved a step change in commercial commitments for participants, discouraging their early involvement in the buy-back market. Powergen also commented on the fact that as this was the first occasion on which Transco had had to make real use of the buy-back mechanism, many parties may have been "feeling their way".

4.54 Powergen stated that it does not factor any potential smear back of costs into its pricing strategy. Instead it considers that the exposure of capacity holders to some of the buy-back costs encourages shippers to sell capacity at competitive prices. In particular, selling below the current offer price should reduce the smear-back.

*Ofgem's conclusions*

4.55 Ofgem have concluded that Powergen's explanation of pricing behaviour in the buy-back market is sufficient and no further investigation is required.

4.56 In reaching this decision Ofgem has recognised that Powergen's opportunity cost of forgoing capacity is likely to be high because of the low flexibility it holds under its contractual arrangements and the associated lack of surplus capacity. This could explain the high prices bid to Transco by Powergen in the buy-back market.

### TotalFinaElf

4.57 In its letter of 22 February 2001 Ofgem identified two days on which the Total Fina Elf group of companies traded both with Transco and other shippers at materially different prices. These days were 2 and 23 October 2000. On each occasion the price charged to Transco was significantly higher than the price applied to other shippers.

*TotalFinaElf's response*

4.58 TFE responded that the price of buy-backs reflected the changing market conditions throughout the day and that the prices offered to Transco and to other counter-parties could be explained by timing of these trades. TFE also indicated that it was simply trading up to market prices at the relevant time.

4.59 On 2 October TFE explained that it traded with Transco early in the gas day and traded with another shipper late on the same day. TFE indicated that the sale of capacity to the shipper represented a sale of spare capacity following an offshore supply failure.

4.60 On 23 October TFE explained that it traded with another shipper in the middle of the day when there was a perception of spare capacity in the market. Indeed Transco was selling within day firm capacity at the time. By contrast the sale of capacity to Transco on that same day occurred outside of normal working hours and resulted in TFE re-nominating its gas flows down, thereby indicating that this was not a sale of spare capacity.

4.61 TFE also stated that a major factor affecting its bids in the capacity buy-back market during October are the opportunity costs of shifting gas sales from the winter to the summer when gas prices are generally lower.

4.62 TFE noted that there were several other market factors that resulted in overall high buy-back prices, including:

- Transco scales back interruptible capacity prior to initiating buy-back actions. These interruptions signal the existence of a constraint to the market and force shippers into the secondary market to secure firm capacity, raising the prices for capacity before Transco enters the buy-back market. Transco then enters the market as a distressed (spot) buyer by signalling its intention to buy. This indicates a physical capacity constraint and increases the market price of capacity. TFE therefore indicated that Transco should be able to contract forward; and

- in common with other shippers, TFE has operational constraints including the employment of junior traders on night shifts and the inability to update continually the opportunity cost analysis underlying the pricing decisions. As a consequence, pricing decisions may include a higher risk premium when conducted outside of office hours.

4.63 TFE questioned whether it could be deemed to be in a dominant position given that they only held 10% of the available capacity at St. Fergus.

4.64 TFE also explained that it has a complete separation between its marketing and European trading group. This separation implies that the trading department would not be in a position to take the smear back of revenue into account when pricing buy-back offers.

*Ofgem's Conclusion*

4.65 Ofgem have concluded that TFE's explanation of pricing behaviour in the buy-back market is sufficient and no further investigation is required.

4.66 Ofgem accepts TFE's explanation of the differential between prices charged to Transco and to other shippers. We appreciate the high opportunity costs of selling capacity back to Transco faced by TFE and the fact that trades with Transco and with other shippers occurred at different times of the gas day under substantially different market conditions.

### *Ofgem's Conclusions*

**Pricing behaviour in the buy-back market**

4.67 In reaching its conclusions with respect to the individual shippers that have been the subject of this investigation, Ofgem has assessed their conduct against a benchmark of what we would expect to see in a competitive process. Against this benchmark, we have found no evidence of anti-competitive behaviour.

4.68 In a competitive process, Ofgem would expect to see, over time, the price at which capacity is bought back from shippers by Transco to reflect the opportunity costs to shippers of releasing capacity. We would also not expect to see, over time, any sustained difference between the prices at which capacity is sold on the secondary markets between shippers and the price at which the same capacity would be sold to Transco.

4.69 Ofgem does recognise however, that the buy back market is dynamic and that variations in price within-day and over time are consistent with competitive price movements. In particular, we recognise that shippers' opportunity costs vary over time both within-day and over the longer term (e.g. where gas contract inflexibility may increase the opportunity costs associated with selling capacity). This was clearly evidenced in each of the individual shipper cases outlined above.

4.70 Ofgem also accepts the argument that has been made by some shippers that it may be legitimate for shippers to attempt to capture a margin in a competitive environment. However, in a competitive market such a margin should ultimately be eroded with prices reaching levels that reflect opportunity costs.

4.71 Going forward, Ofgem will continue to monitor the market. If there is evidence that prices in the buy back market appear not to be following a path that one might expect to see in a competitive market, reflecting movements in opportunity costs, Ofgem will investigate. Ofgem would, if necessary, take action if Ofgem believed that a company's conduct was causing appreciable harm to competition and/or customers.

### Market power and competitive bidding

4.72 A number of shippers that were the subject of this investigation indicated that their share of capacity rights was insignificant and as such, they were not in a position to exert any market power in the buy-back market.

4.73 Ofgem considers that the proportion of capacity held at a terminal is only one indicator of market power in the secondary market. We would, as set out above, judge a company's actions by carefully analysing the economic effects of that conduct. The ability to participate in the secondary market is likely to be determined by both the primary allocation of capacity and the flexibility of contractual relations with producers and customers. Consequently, we cannot conclude a priori that a shipper is not exerting market power based on a relatively modest market share.

### Pricing strategy and capacity neutrality

4.74 Ofgem considers that, over time, in a competitive process, the price at which shippers sell capacity back to Transco will reflect shippers' opportunity costs of releasing that capacity. In these circumstances, a shipper would not be able to influence the market price for buy-backs and would simply bid to reflect its opportunity costs. Therefore, we do not believe that it is legitimate for shippers to seek to factor up their prices in an attempt to mitigate their exposure to capacity neutrality.

4.75 For example, a company with market power might find itself in a position where it can raise the price Transco pays to buy back capacity, independently of the actions of other market participants. With sufficient market power, a company may be able to raise prices such that the price it received (net of its share of the smear-back) was at or above its own opportunity costs. Other shippers would face significant additional costs through the residual smear-back because of the companies action. Such an offer strategy, could if the effects were maintained for a sustained period, have anti-competitive effects.

### Maturity of the buy-back market in October 2000

4.76 A number of the respondents highlighted characteristics of the buy back market that could have contributed to the high prices paid by Transco:

- the high buy-back prices paid by Transco in October might have been the consequence of an immature market. Shippers experiencing the first occasion of significant buy-back activities were likely to ensure that systems, processes and proper controls were in place before entering into commitments. This may have negatively affected the depth and liquidity of the early days of the buy-back market;

- shippers were likely to be unfamiliar with the IT system at the beginning of October; and

- shippers needed to learn how to price the buy-backs. Pricing decisions were reported as being heavily based on the prices prevailing in the buy-back market on the previous day during the beginning of the month.

**Transco's activity in the buy-back market**

4.77 During the course of the investigation shippers suggested that Transco's behaviour may have exacerbated the high prices in the buy-back market. In particular, shippers commented that:

- Transco's timing of the trades may have exacerbated buy-back prices. Shippers argued that Transco took several buy-back actions very early in the gas day when only a small number of shippers are actually capable of trading due to operational constraints. This reduces the liquidity and effective supply of capacity to the buy-back market;

- Transco often exhibited a lack of trading expertise, for example by accepting all available offers of capacity before shippers and traders were able to consider competitively re-pricing or making new offers; and

- Transco lacks a sufficient incentive under the buy-back regime. In particular, the caps and collars and sharing factors do not generate sufficient incentives on Transco to develop trading expertise.

4.78 Ofgem considers that Transco behaviour in the buy-back market is important to understanding the events experienced in the buy-back market in October 2000. In particular, Ofgem considers that Transco:

- often takes buy-back actions very early or late in the day when shippers do not always have the necessary trading or operational staff to place bids on the RGTA screens; and

- often takes a small number of large buy-back actions rather than trying to generate more competitive bidding by purchasing small amounts of capacity at competitive prices.

4.79 Ofgem believes that there is potential for Transco to reduce the costs of buy-backs by trading during normal business hours and by reducing the number of large volume buy-back actions taken.

4.80 Ofgem also believes that there are a number of reforms that could improve depth, liquidity and competition in the buy-back market. In particular:

- Transco should be allowed to post bids to purchase capacity on the RGTA system, in order to facilitate and encourage competitive bidding by shippers during periods of constraints. By signalling the price at which it is willing to purchase capacity, Transco may encourage re-pricing of non-competitive bids and also attract shippers who may not have otherwise bid into the buy-back market (or encourage competition between terminals); and

- Ofgem has consistently argued that Transco should consider developing new contractual tools including forwards and options contracts for purchasing capacity well ahead of the gas day. This would prevent Transco always approaching the market as a distressed purchaser. More shippers are likely to be able to participate and offer lower prices as they will have greater flexibility to source other gas given greater lead times and notice periods.

***Summary***

4.81 Based on the data and information supplied to Ofgem in its investigation of pricing behaviour in the capacity market we did not find any clear evidence of behaviour warranting further investigation and action.

4.82 We have, however, identified a number of potential improvements to the current arrangements that could improve the operation of the buy-back market and lower costs in the event of constraints.

# 5. Investigation into shipper overrun behaviour

### *Background*

5.1 In Chapter 3 we explained Ofgem's position on overruns in the capacity market. This position has been outlined in numerous letters that Ofgem sent to shippers and other interested parties. These letters are reproduced in Appendix 2.

5.2 In these letters, Ofgem set out its position that consistently overrunning at a terminal where a shipper has failed to purchase capacity could constitute a breach of the Gas Shippers licence.

5.3 Ofgem monitors shipper overruns as part of our routine market surveillance. Both these explanations could imply consistent overrunning behaviour that may endanger the safe and efficient operation of Transco's transmission system.

5.4 In October 2000, when the NTS experienced severe capacity constraints, Ofgem commenced an investigation on overruns and found that some shippers repeatedly overran between July and October 2000. In particular, these shippers overran on some days when the NTS was constrained and Transco was forced to buy-back capacity.

5.5 In this chapter we report the results of our investigation into the overruns incurred by five shippers during the period July to October 2000. These five shippers were required by Ofgem to provide an explanation for their overruns. The five shippers were Innogy, Total Fina Elf, Accord, Scottish and Southern Energy and Conoco ("the shippers"). We outline below the activities of each shipper, their responses and Ofgem's conclusions.

5.6 We also report on our investigation into the conduct of Marathon Oil UK Ltd ('Marathon'). This part of the investigation stemmed from discussions with two shippers who indicated that their overruns were the results of over-deliveries of gas (relative to nominations) by Marathon.

5.7 Based on the data and information supplied to Ofgem by these shippers, we found no evidence of behaviour warranting further investigation and/or action.

### *Individual shippers warranting further investigation*

**Capacity overrun analysis**

5.8 Ofgem's initial analysis showed that on a number of occasions, for the period from July to October 2000, these five shippers flowed volumes of gas in excess of their entry capacity entitlements. A number of these shippers also had overran at particular terminals on days when Transco was buying-back capacity.

5.9 The overruns identified in Ofgem's initial analysis are reported in Table 5.1, which displays overruns greater than or equal to 1 GWh.

**Table 5.1 - Selected shippers' overruns for the period July to October 2000**

| Date | Shipper | Terminal | Volume (GWh) | Transco buy-backs |
|---|---|---|---|---|
| 25/09/00 | Accord | St Fergus | 0.9 | |
| 26/09/00 | Accord | St Fergus | 1.4 | |
| 28/09/00 | Accord | St Fergus | 1.7 | |
| 29/09/00 | Accord | St Fergus | 1.3 | St. Fergus |
| 15/10/00 | Accord | Teesside | 4.5 | St. Fergus and Teesside |
| 25/08/00 | Conoco | Theddlethorpe | 24.7 | |
| 04/09/00 | Conoco | Bacton | 3.8 | |
| 18/09/00 | Conoco | Bacton | 3.8 | |
| 09/09/00 | Innogy | Theddlethorpe | 1.1 | |
| 22/09/00 | Innogy | St Fergus | 11.3 | |
| 09/10/00 | Innogy | St Fergus | 6.7 | St. Fergus |
| 10/10/00 | Innogy | Theddlethorpe | 2.5 | Teesside and St. Fergus |
| 16/10/00 | Innogy | Teesside | 6.3 | St. Fergus |
| 20/10/00 | Innogy | Theddlethorpe | 4.7 | St. Fergus |
| 21/10/00 | Innogy | Theddlethorpe | 5.4 | |
| 22/10/00 | Innogy | Theddlethorpe | 3.4 | |
| 31/10/00 | Innogy | Theddlethorpe | 1.5 | |
| 11/07/00 | SSE | St Fergus | 2 | |
| 14/07/00 | SSE | St Fergus | 7 | St. Fergus |
| 15/07/00 | SSE | St Fergus | 3 | |
| 13/10/00 | SSE | St Fergus | 3.8 | St. Fergus |
| 17/09/00 | TFE | Teesside | 14.7 | |
| 25/09/00 | TFE | St Fergus | 1.8 | |
| 26/09/00 | TFE | St Fergus | 2 | |
| 27/09/00 | TFE | St Fergus | 2 | |
| 28/09/00 | TFE | St Fergus | 2 | |
| 29/09/00 | TFE | St Fergus | 2 | St. Fergus |
| 15/10/00 | TFE | Teesside | 2.6 | St. Fergus and Teesside |

5.10 From this table we see that amongst these shippers:

- St. Fergus (15) had the largest incidences of overruns followed by Theddlethorpe (7), Teesside (4) and Bacton (2);
- the average level of overruns was 4.6 GWh, although there were three incidences of overrunning more than 10 GWh;
- there were 10 overruns that coincided with days of system buy-backs; and
- the largest number of overruns in excess of 1 GWh occurred in September (14), followed by October (10), July (3) and August (1).

5.11 Ofgem wrote to the above shippers on 22 February 2001 indicating that it believed that there was prima facie evidence of a breach of Standard Condition 2 (as it then was) of the Gas Shippers' licence. The letters however provided each shipper with an opportunity to explain their behaviour and to present any information that may be relevant or which may alter Ofgem's initial view.

5.12 Following these letters several meetings and, in some cases, exchanges of correspondence occurred between Ofgem and the shippers that were requested to explain their behaviour.

**Shippers' responses to Ofgem evidence**

5.13 All of the shippers' identified above responded to the evidence of overruns presented by Ofgem. A number of themes in the responses emerged including:

- contractual terms and the allocation process;
- offshore production problems;
- curtailment of interruptible capacity;
- shippers entering the gas day short of entry capacity; and
- shipper staff and administrative errors.

5.14 In addition, Ofgem obtained evidence to suggest that Marathon had taken actions that resulted in a number of overruns that were attributed by the allocation process. We therefore, subsequently wrote to Marathon and asked them to provide an explanation for these overruns. Their response is summarised after the responses of the original shippers under investigation.

5.15 Shippers also highlighted:

- the infrequent nature of the overruns, claiming that the small number of occurrences could not constitute evidence of 'consistently overrunning'; and
- the relative size of the overruns and that they were insufficient to effect the efficient operation of the NTS.

5.16 In the sections below, we discuss each individual shipper's response and Ofgem's views with regard to that response.

**Accord**

5.17 In its letter to Accord of 22 February 2001, Ofgem identified four overruns at St Fergus and one overrun at Teesside of approximately 1 GWh or above. These overruns are listed in Table 5.1.

*Accord's response*

5.18 In response to Ofgem's concerns, Accord stated that the overruns that occurred at St Fergus were the result of CVA process for allocating gas. Accord stated that it received gas under contract from Marathon. Accord explained that on the relevant days it had purchased sufficient capacity to cover the quantity it had nominated for delivery.

5.19 Subsequently however, an additional 50,000 therms was allocated to Accord through the CVA process on each of the relevant days at St Fergus. This additional gas had been allocated to Accord at the request of their contractual counter-party, Marathon. Under existing CVA rules, Marathon's posting of a delivery of gas as a seller takes precedence in determining the final allocation to the CVA.

5.20 As a consequence Accord was allocated the additional gas and incurred overrun charges on 25, 26, 28 and 29 September 2000. Marathon accepted that the nominations had been made in error and settled Accord's overrun charges.

5.21 As regards the overrun that occurred at Teesside on 15 October 2000, Accord stated that the excess gas was obtained under a contract according to which the seller nominates the quantity subject to a maximum limit. At the day-ahead stage, Accord received a nomination for 116,128 therms from the seller. At that time, Accord had 400,000 therms of capacity to cover this and other trades. However, the seller subsequently increased the nomination to 488,195 therms.

5.22 In an attempt to avoid the overrun charges, Accord stated that they:

- obtained 100,000 therms of within-day firm capacity;
- purchased 400,000 therms of daily interruptible capacity; and
- transferred a small amount of capacity from BGT.

5.23 This would have been sufficient to cover all of Accord's trades. However, Transco fully scaled back the interruptible capacity. In response, Accord tried to secure additional within-day firm capacity at prices above the prevailing buy-back price, but its attempts were unsuccessful. As a result, Accord overran.

*Ofgem's Conclusions*

5.24 Ofgem accepted Accord's explanation of the overruns at St Fergus. In particular, Ofgem subsequently established from Marathon that the allocation of additional gas to Accord was the result of an allocation error on the part of Marathon. The events that surrounded this error are discussed in further detail below.

5.25 Ofgem is however concerned by Accord's reliance on significant quantities of interruptible capacity to meet its flows under the contract at the Teesside terminal on 15 October 2000.

5.26 Although Ofgem accepts that interruptible capacity has a role to play in allowing a shipper to manage the risk associated with changes in gas flows we would expect a shipper to assess the probability of interruption on the day. In particular, if a shipper purchases gas under a contract where the seller nominates the flows, the shipper would not be able to reduce flows on the day in the event that the capacity rights were interrupted. A shipper relying on significant quantities of interruptible capacity to avoid overrunning would therefore have to be sure that the probability of interruption was small and/or that it could secure sufficient firm capacity over operational time-scales to avoid interruption.

5.27 Ofgem considers that a shipper undertaking a course of conduct that hinders Transco's ability to efficiently manage constraints could be considered to be in breach of Standard Condition 2 of its Gas Shipper's licence. On this occasion however Ofgem accepted that the overrun at Teesside resulted from a one-off commercial error on the part of Accord and did not represent a course of conduct that could be deemed to be in breach of Standard Condition 2, as it then was.

**Conoco**

5.28 In its letter to Conoco of 22 February 2001, Ofgem identified two overruns at Bacton and one large overrun of approximately 25 GWh at Theddlethorpe. These overruns are set out in Table 5.1.

*Conoco's response*

5.29 Conoco stated that when it purchased capacity in the summer 2000 MSEC auctions it had forecasted low levels of production through the Theddlethorpe terminal in the summer months. However, subsequently a number of factors changed this expectation including a rise in gas prices, earlier than scheduled production from offshore fields linked to Theddlethorpe and maintenance at other non-Theddlethorpe linked fields.

5.30 As a result it was necessary for Conoco to secure additional capacity in excess of its MSEC holdings to enable it to flow additional gas. Conoco states that on the majority of days this capacity was secured on a within-day basis.

5.31 On 25 August, Conoco indicated that it was experiencing considerable uncertainty associated with gas flows due to liquids problems at the Theddlethorpe terminal. On this date Conoco nominated gas flows over and above its holdings of firm and interruptible capacity as it was not expecting all of the gas it had nominated would flow.

5.32 Conoco had also formed an expectation on the basis of previous experience that it would be able to secure sufficient within-day capacity in the event that its full nomination was delivered. Conoco therefore chose to wait until later in the gas day before deciding whether to acquire additional within-day firm capacity from Transco.

5.33 Later, when Conoco was informed that the majority of its nomination would be met it attempted to obtain within-day firm capacity. However, despite these attempts it was unable to secure sufficient capacity from either Transco or on the secondary market to meet its nominations. As a result, later in the evening of 25 August Conoco reduced its gas flows in an attempt to reduce its exposure to overrun charges. The reductions in flows however proved insufficient and Conoco incurred a significant overrun penalty.

5.34 Conoco attributed the two overruns at Bacton to an operational error on the part of Conoco's agent. On both occasions, Conoco had contracted for gas with a producer who had failed to secure sufficient capacity to land their gas. This situation was being managed through purchases of within-day firm and day-ahead interruptible capacity. However, on 4 and 18 October 2000, the agent failed to check whether the capacity held was sufficient to cover the nominated flows, resulting in the overruns. Conoco has indicated that it has introduced changes to its operating procedures in order to reduce the likelihood of future overruns.

*Ofgem's Conclusions*

5.35 Ofgem considers that the failure of a shipper to secure capacity rights prior to flowing gas onto the NTS may constitute a breach of Standard Condition 3, formerly Standard Condition 2 of the Gas Shippers' licence.

5.36 In this respect Ofgem is concerned by Conoco's failure to secure sufficient capacity at the Theddlethorpe terminal prior to nominating its gas flows. Ofgem considers that conduct of this nature could potentially prejudice the efficient operation and balancing of the NTS particularly in the event that a terminal is constrained.

5.37 Ofgem considers that if all shippers adopted a strategy of this nature the physical and commercial consequences could be significant, particularly where there is insufficient capacity relative to demand and a terminal is genuinely constrained.

5.38 Ofgem accepts that there is always a level of uncertainty regarding gas flows. However this uncertainty does not permit shippers to nominate more than their capacity holdings either in the expectation that the gas will not flow or in the expectation that they will obtain sufficient capacity. In this respect, Ofgem also considers that nominations of this nature could potentially mislead Transco, as system operator, as to end of day gas flows and may therefore be in breach of Standard Condition 3, paragraph 3 (formerly Standard Condition 2, paragraph 3) of the Gas Shippers' licence.

5.39 Although the result of Conoco's conduct was only one large overrun, Ofgem is concerned that the strategy adopted by Conoco had the potential to prejudice Transco's operation of the NTS. In this respect the strategy could place Conoco in breach of its Gas Shippers licence.

5.40 Ofgem has therefore requested that Conoco ensure that in the future its nominations are consistent with its capacity holdings and that Conoco does not nominate over and above these holdings. Conoco would be free to re-nominate intended flows as its capacity position evolved during the day.

5.41 In relation to the Bacton overruns, Ofgem has accepted Conoco's explanation that the overruns were attributable to operational errors. Ofgem has also noticed that Conoco has not incurred any over runs in excess of 1 GWh since October 2000.[17] This provides some evidence that the changes to Conoco's operational procedures have improved its performance.

**Innogy (NPower)**

5.42 In its letter to Innogy of 22 February 2001 Ofgem identified nine overruns in excess of 1 GWh at the Theddlethorpe, Teesside and St Fergus terminals. These overruns are listed in Table 5.1.

[17] Based on data received to July 2001.

*Innogy's response*

5.43 In responding, Innogy explained that the six overruns identified at Theddlethorpe were attributable to information problems arising from a change in the seller's representative role in relation to Innogy's offshore gas sales contract. In particular, a newly appointed seller's representative failed to provide accurate and timely information to Innogy relating to gas flows at the Theddlethorpe terminals following operational difficulties experienced offshore.

5.44 Under its contract any shortfalls of deliveries from the seller are made up through deliveries of traded gas. However, in this case the seller's representative had failed to provide information about the level of traded gas being delivered. As a consequence of these information problems, Innogy failed to secure sufficient capacity to cover the gas deliveries.

5.45 Innogy has subsequently arranged to receive improved information to enable it to accurately nominate and secure sufficient entry capacity. In addition, the offshore operational problems have been resolved.

5.46 Innogy attributed the remaining overruns at St Fergus and Teesside to staff administrative errors. In particular, Innogy failed to instigate downward nominations on its gas contracts following the scale back of interruptible capacity on 22 September and 16 October and Innogy's sale of capacity to Transco on 9 October.

5.47 Following these incidents Innogy has indicated that it re-trained its trading staff and up-dated its operating procedures to minimise the potential for future errors.

*Ofgem's Conclusions*

5.48 Ofgem accepts that the additional information provided by Innogy adequately explains the overrun incidents. Ofgem has also noted that Innogy has not overrun at any terminal since October 2000, suggesting that the actions it has taken to reduce the possibility of similar errors in future appear to have been successful.

### Scottish & Southern Energy

5.49 In its letter to Scottish and Southern Energy ('SSE') of 22 February 2001 Ofgem identified four overruns at the St Fergus terminal in excess of 1 GWh for the period July to October 2000. One of these overruns occurred at a time when Transco was buying-back capacity at this terminal. These overruns appear in Table 5.1.

*Scottish and Southern Energy's response*

5.50 In response to Ofgem's letter, SSE explained that the overruns that occurred on 11 and 14 July 2000 and 13 October 2000 were caused by errors on the part of the company's traders and operators. As a result of these errors SSE has reminded traders of the need for accuracy in their operations. In addition, SSE has implemented revised procedures to reduce the potential for future errors to occur.

5.51 On 15 July 2000, SSE overran because its contractual counter-party did not recognised SSE's downward renomination on its beach contract with SSE. SSE has indicated that it is discussing better ways to ensure that nominations are acted upon under the contract.

*Ofgem's Conclusions*

5.52 Ofgem has accepted SSE's explanation of the four overruns identified in our letter of 22 February 2001. In particular, Ofgem is satisfied that there is no evidence that SSE has engaged in a course of conduct that involves incurring overruns for commercial purposes or is experiencing ongoing difficulties in managing its physical position in a manner that is potentially prejudicing the efficient operation of the system. Ofgem has also recognised the steps SSE has taken to avoid the recurrence of similar incidents.

### TotalFinaElf

5.53 In its letter of 22 February 2001 Ofgem identified seven overruns at the St Fergus and Teesside terminals in excess of 1 GWh. These overruns are described in Table 5.1. An overrun of 2.6 GWh occurred at Teesside on 15 October 2000 at a time when Transco was buying-back capacity both at St Fergus and Teesside at high prices.

*TotalFinaElf's response*

5.54 TFE explained that with the exception of the overrun on 15 October 2000 all of the overruns shown in table 5.1 were the result of actions undertaken by contractual counter-parties.

5.55 TFE stated that the overrun on 17 September at Teesside resulted from actions take under its supply contract by the counter-party. In particular, TFE stated that although it nominated a zero flow to the counter-party it was supplied with a normal full gas delivery which was subsequently allocated to TFE allocated to TFE through the CVA process.

5.56 TFE attributed all of the St Fergus overruns to a beach trade agreement with Marathon under which Marathon erroneously double-posted deliveries to the CVA. In accordance with the CVA Rules, the seller's posting takes precedence over the buyer's. Therefore, the gas was allocated to TFE and it consequently overran. TFE provided evidence showing that Marathon accepted responsibility for these overruns and had reimbursed TFE for the overrun charges incurred.

5.57 TFE accepted responsibility for the overrun that occurred at Teesside on 15 October. TFE explained that at that time it was subject to a contract which required it to accept the delivery of a certain quantity of gas. The capacity necessary to cover these flows was usually purchased in the secondary market. On 15 October the quantity delivered was greater than normally expected and TFE was unable to secure sufficient capacity.

*Ofgem's conclusions*

5.58 Ofgem accepted TFE's explanations for the overruns incurred during September and October 2000. Ofgem also notes that based on the information provided by TFE and the occurrence of only one significant overrun since October 2000[18] it appears that generally TFE has taken sufficient action to address the operational problems it experienced in September and October 2000.

[18] Based on data supplied to Ofgem to July 2001.

5.59 Nevertheless, Ofgem is concerned by TFE's failure to secure sufficient capacity at the Teesside terminal on 15 October 2000 prior to nominating its gas flows. As outlined above, we believe that a shipper, by repeatedly nominating gas above its capacity holdings and attempting to secure the necessary additional capacity on the day could prejudice the efficient operation of and balancing of the NTS.

5.60 Whilst TFE's strategy produced only one overrun on 15 October, Ofgem has nevertheless expressed its concerns to TFE that a course of conduct of this nature could prejudice the efficient operation of the NTS and could mislead Transco regarding end of day flow levels. This could place TFE in breach of its Gas Shipper's licence. Ofgem has therefore requested that TFE ensure that in the future its nominations are consistent with its capacity holdings.

**Marathon**

5.61 Ofgem wrote to Marathon on 11 June 2001 following meetings with representatives of Accord and TFE. During these meetings both Accord and TFE attributed a number of the overruns identified by Ofgem to the actions of Marathon.

5.62 In each of these meetings Accord and TFE had indicated that they had incurred overruns on particular days as a result of the allocation of additional gas via the CVA process. In particular, the allocations of this additional gas were undertaken at the request of Marathon as a gas seller. Under existing Claims Validation rules, Marathon's posting of a delivery as a seller takes precedence in determining the final allocation to the CVA.

5.63 In its letter of 11 June 2001, Ofgem raised concerns that Marathon may have entered gas onto the NTS without having a licence to do so. Ofgem indicated that this could give rise to a breach of section 5 of the Gas Act. In this respect, Ofgem indicated that it would view with concern any conduct on the part of a gas producer that involved effectively dumping gas onto the NTS and subsequently allocating that gas through to contracting parties under the CVA process.

5.64 As a consequence Ofgem requested the details of the names and activities of the gas contracting arms of Marathon to determine whether the contracts with Accord and TFE had been entered into with the production or shipping arm of Marathon.

5.65 To the extent that the contracts may have been entered into with Marathon as a shipper, Ofgem also raised concerns that Marathon may have failed to ensure that Transco had been provided with nominations of end of day gas flows onto the NTS. In particular, Ofgem raised concerns that both TFE and Accord had been allocated gas flows by Marathon that they were unaware of and had not previously nominated to Transco. Ofgem had concerns that this conduct had the potential to mislead Transco as system operator as to end of day gas flows and may involve a breach of the Gas Shipper's licence.

*Marathon's response*

5.66 In its response Marathon indicated that the overruns incurred by TFE and Accord were the result of an error made by Marathon's claim system operator two weeks after the relevant gas flow days. As Marathon's posting of deliveries takes precedence over Accord's and TFE's own claims, Marathon transferred more gas to them than was intended. As a consequence, Marathon had unused entry capacity and was short of gas, which it had to buy from Transco via system cash-out.

5.67 Marathon subsequently requested that the error be reversed through the CVA process. However, this request was unable to be accommodated under the timetable associated with the CVA rules.

5.68 Marathon indicated that in net terms Transco had sufficient entry capacity to accommodate the gas that flowed onto the system on the relevant days and that Marathon would have had sufficient capacity had it retained title to the gas and not erroneously allocated title to TFE and Accord.

5.69 Marathon also indicated that it was acting in its capacity as a shipper in possession of a Gas Shipper's licence and that under the CVA process the subsequent allocation to TFE and Accord represented a shipper to shipper transaction.

*Ofgem's conclusions*

5.70 Ofgem accepted Marathon's explanation of the contractual relationship that was in operation with respect to the relevant gas trades.

5.71 Ofgem also accepted that Marathon's error, which was made more than two weeks after the gas flow day, did not have the potential, on the flow day, to mislead Transco as to end of day flows.

5.72 Further, Ofgem believes that the NTS was not affected on the gas day by the error, as in net terms, Accord, TFE and Marathon in its shipper role had enough capacity entitlements to cover the gas flows.

### *Conclusions*

5.73 Based on the data and information supplied to Ofgem in its investigation of pricing behaviour in the capacity market we did not find any clear evidence of behaviour warranting further investigation and/or action.

5.74 Ofgem has however identified a number of concerns regarding shipper behaviour that could give rise to a course of conduct that may be in breach of Standard Condition 3, formerly Standard Condition 2 of the Gas Shipper's licence.

5.75 In particular, Ofgem considers that the failure to secure sufficient entry capacity prior to nominating gas flows could potentially prejudice the efficient operation and balancing of the NTS, particularly in the event that a terminal is constrained.

5.76 Ofgem considers that if all shippers adopted a strategy, or course of conduct of this nature, the physical and commercial consequences could be significant. This may also lead to a breach of Standard Condition 3 of the shipper's licence.

5.77 Ofgem is also concerned that any course of conduct in which a shipper is providing nominations to Transco in excess of capacity holdings could potentially mislead the system operator as to end of day gas flows. Such a course of conduct may also constitute a breach of Standard Condition 3, paragraph (3) of the Gas shippers' licence.

5.78 In response to these concerns, Ofgem has issued warnings to Conoco and TFE that they do not engage in any course of conduct which would involve nominating over and above their capacity holdings when entering the day short of capacity.

5.79 Ofgem has also raised concerns that shippers with seller's nomination contracts should exercise caution in relying on significant quantities of interruptible capacity to avoid incurring overrun charges.

5.80 Ofgem considers that in these circumstances a shipper relying on interruptible capacity would need to be confident that the probability of interruption was minimal and/or that it could secure sufficient firm capacity on the secondary market quickly over operational time-scales in the event of interruption. Any course of conduct that hindered Transco's ability to efficiently manage system constraints could be considered to be in breach of Standard Condition 3 of the Gas Shippers' licence.

# 6. Conclusions and way forward

***Conclusions***

6.1 During October 2000 Transco was unable to deliver against the firm capacity it had sold in the MSEC auctions for winter 2000/2001. As a result, Transco was required to buy-back significant volumes of capacity in the capacity market often at very high prices. The bulk of the resulting costs were paid by shippers and, ultimately, customers.

6.2 Warmer than average weather in October led to lower GB gas demand. As a result, Transco faced constraints in the volume of gas it could evacuate from Northern terminals (such as St Fergus) to meet demand that was predominantly located in the South of the country. Shippers wanted to flow more gas through the St Fergus terminal to meet demand than Transco was able to accommodate. Transco was unable to evacuate all of the gas that shippers nominated to flow against their firm capacity rights at the St. Fergus entry terminal.

6.3 The significant costs of capacity buy-backs during October 2000 led Ofgem to assess the pricing behaviour of shippers in the buy-back market. Ofgem sought to determine whether there was any evidence of anti-competitive behaviour by shippers and/or harm to customers.

6.4 Ofgem also investigated shipper overruns to determine whether any shippers had been consistently overrunning during the period July to October 2000 and in particular during the periods in which Transco was buying back capacity.

**Shipper buy-back market behaviour**

6.5 Ofgem completed an initial analysis of shipper behaviour in the buy-back market in February 2001. This analysis provided some evidence that during the month of October some shippers might have adopted a discriminatory strategy in offering capacity to other shippers and Transco at materially different prices. In a competitive market, arbitrage would ensure that there was no sustained differences in the prices at which capacity was sold to Transco relative to the prices paid in shipper to shipper trades.

6.6 Ofgem's preliminary analysis identified five shippers whose conduct merited further investigation.

6.7 These shippers were:

- BGT;
- Total Fina Elf;
- Amerada;
- Enron; and
- Powergen.

6.8 Following meetings and exchanges of correspondence between these shippers, we did not find any clear evidence of behaviour warranting further investigation and action.

6.9 In reaching these conclusions Ofgem assessed the conduct of the individual shippers against a benchmark of what it would expect to see in a competitive process. In a competitive process, Ofgem would expect over time to see the price at which capacity is bought back from shippers by Transco to reflect the opportunity costs to shippers of releasing capacity. Ofgem would also not expect over time to see any sustained difference between the prices at which capacity is sold on the secondary markets between shippers and the price at which the same capacity is sold to Transco.

6.10 In general, Ofgem accepted that the higher prices offered to Transco by the shippers identified above reflected market conditions and the opportunity costs of forgoing capacity prevailing at the time.

6.11 Ofgem's investigation has highlighted a number of possible improvements to the arrangements. These could lead to lower costs in the event of constraints in the future. The improvements identified include:

- enabling Transco to purchase back capacity ahead of the gas day;
- enabling Transco to post bids for capacity; and
- improvements in Transco's trading strategy when buying-back capacity.

6.12 Ofgem will continue to closely monitor all shippers behaviour in the buy-back market as part of its routine market surveillance.

**Shipper overrun behaviour**

6.13 Ofgem completed its initial analysis of capacity overruns in February 2001. This analysis identified five shippers that had each overrun on a number of occasions by significant volumes, for the period from July to October 2000. These shippers were:

- Innogy;
- Accord;
- Scottish and Southern Energy;
- Total Fina Elf; and
- Conoco.

6.14 Subsequently Ofgem wrote to these shippers to provide them with an opportunity to present evidence to Ofgem to explain their behaviour. In writing to these shippers Ofgem outlined concerns that there was prima facie evidence that each shipper had demonstrated a pattern of consistent overruns potentially in breach of Standard Condition 2 (as it then was) of its licence. Following meetings and exchanges of correspondence between these shippers, Ofgem was able to conclude that none of these shippers had breached the conditions of their licences.

6.15 Ofgem was satisfied with the explanations of overruns provided by the five shippers that were the subject of the investigation. In several cases, shippers had indicated that the overruns were the result of operational or staff errors. In these cases the shippers involved indicated that they had introduced changes to operational procedures to reduce the likelihood of future overruns. In other cases shippers indicated that the errors were the result of offshore physical and contractual problems, as well as contractual and allocation issues.

6.16 Ofgem however identified a number of concerns that some shippers had failed to secure sufficient entry capacity prior to nominating gas flows. Ofgem is concerned that a course of conduct of this nature could potentially prejudice the safe and efficient operation of the NTS particularly in the event that a terminal is constrained and may therefore be in breach of Standard Condition 3 of the Gas Shippers' licence.

6.17 Ofgem is also concerned that any course of conduct in which a shipper is providing nominations to Transco in excess of capacity holdings could potentially mislead the system operator as to end of day gas flows and may therefore be in breach of Standard Condition 3 of the Gas Shippers' licence.

6.18 During meetings two shippers indicated that a number of their overruns were attributable to actions taken under contract with Marathon. In each case, the shippers indicated that Marathon had posted the delivery of additional gas to the CVA over and above each of these shippers' capacity entitlements. Marathon indicated that the posting of the additional gas to the CVA was an error. Marathon indicated that it had sufficient capacity on the relevant day to flow the gas onto the system. Ofgem was therefore satisfied that Marathon's conduct did not warrant any further investigation and/or action.

### *Way forward*

6.19 Ofgem's proposals to introduce new System Operator incentives from April 2002 and new long term capacity rights will strengthen the incentives on Transco to develop the arrangements and manage the costs and risks associated with constraints and buy backs more efficiently.

6.20 Ofgem will continue to monitor shipper conduct in the capacity and gas markets as part of its ongoing wholesale market surveillance.

# Appendix 1 Regulatory framework

### *The Gas Act 1986*

1.1 The Gas Act 1986 (the Gas Act), as amended by the Utilities Act 2000, provides for the regulation of the onshore gas arrangements in Great Britain and for the separate licensing of Gas Transporters (GTs), gas shippers and gas suppliers. Transco is the largest Gas Transporter in Great Britain. The Gas Act also provides for the creation of the Gas and Electricity Markets Authority (the Authority).

1.2 The duties of the Authority are set out in section 4AA of the Gas Act. The principal objective of the Authority in carrying out its functions under the Gas Act is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between those engaged or concerned with the shipping, transportation or supply of gas or engaged in commercial activities relating to such activities. In carrying out its functions under the Gas Act in a manner which furthers the principal objective, the Authority shall have regard, amongst other things, to the following:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met; and
- the need to secure that licence holders are able to finance the carrying on of the activities which they are authorised or required by their licences to carry on.

1.3 In performing such duties the Authority is required to take account of the interests of a number of groups within the GB population and of consumers in related industries.[19]

### The Utilities Act 2000

1.4 The Utilities Act 2000 amends the Gas Act 1986 in a number of significant ways. The Act gives the Authority new duties as outlined above and functions in

[19] A more detailed discussion is included in "*Long term signals and incentives foir investment in transmission capacity on Transco's National Transmission System*", Ofgem, March 2001.

relation to licensing and setting performance standards. The Act will also give the Authority the power to impose financial penalties on companies found to be breaching, or to have been in breach of, licences issued to them under the Gas Act 1986 or Electricity Act 1989. Gas Transporters will also have some additional duties placed upon them. The Utilities Act 2000 was given Royal Assent in July 2000. The majority of the provisions of the Utilities Act 2000 were implemented on 1 October 2001. The provisions relating to the use of financial penalties, however, require secondary legislation before Ofgem can impose financial penalties. This secondary legislation has yet to be made. These powers will apply to all licensees.

1.5 By section 76 of the Utilities Act 2000, the term “Public Gas Transporter” has become “Gas Transporter”.

### *Competition legislation*

#### The Competition Act

1.6 The Competition Act 1998 prohibits anti-competitive agreements and abuse of a dominant position. Under the Act the OFT and Ofgem enforce Chapter 1 and 2 prohibitions using their concurrent powers. Chapter 1 prohibits agreements between undertakings, decisions by associations of undertakings or concerted parties which have the object or effect of preventing, restricting or distorting competition in the United Kingdom and which may affect trade in the United Kingdom.

1.7 Chapter 2 prohibits conduct by one or more undertakings, which amounts to the abuse of a dominant position in a market in the United Kingdom, which may affect trade in the United Kingdom. Under the Competition Act 1998 the Authority has the power to impose financial penalties of up to 10 per cent of turnover on companies infringing the prohibitions of the Act.

#### Fair Trading Act 1973

1.8 Under section 36A of the Gas Act 1986, the Authority has concurrent powers with several sections of the Fair Trading Act 1973 in respect of activities which require a licence under the Gas Act 1986, and its ancillary activities. All other sectors of the economy (such as upstream and offshore activities not ancillary to those activities) are overseen exclusively by the OFT.

1.9 Under the Fair Trading Act 1973, the Authority has powers in relation to monopoly situations. Where it appears to the Authority that there are grounds for believing that a monopoly situation may exist, the Authority may require any person that produces goods or supplies services within the United Kingdom to provide documents as specified by the Authority. Where it appears to the Authority that a monopoly situation exists or may exist, it may make a monopoly reference to the Competition Commission to investigate, broadly, whether such a monopoly is operating against the public interest. The Authority may accept undertakings from relevant persons that it considers would be sufficient to deal with the adverse effects of the monopoly situation in lieu of a monopoly reference to the Competition Commission. The Secretary of State may also make licence amendments in certain circumstances following a monopoly reference.

1.10 Additionally, where the Director General of Fair Trading requests, the Authority must exercise functions under Part III of the Fair Trading Act 1973 in relation to conduct which is, or may be, detrimental to the interests of consumers of gas conveyed through pipes. Part III of the Fair Trading Act 1973 allows the Authority to obtain written assurances from a person carrying on a business for that person to refrain from conduct which is detrimental to the interests of consumers in the United Kingdom or conduct which could, in accordance with the Act, be regarded as unfair to consumers.

### *The Onshore regulatory regime*

1.11 The Gas Act 1986 provides for the licensing of Gas Transporters (GTs), Gas Shippers and Gas Suppliers and imposes a number of conditions on the licensees. Where the Authority is satisfied that a licensee is contravening, or is likely to contravene, any licence condition or relevant obligation, the Act requires it (except in certain specified circumstances) to issue an enforcement order against the licensee under section 28 of the Gas Act 1986. In the past, in issuing an enforcement order under section 28, the Authority could impose a requirement to pay a monetary penalty of such amount as considered appropriate on the licence holder to whom the order related.

1.12 Section 31 of the Gas Act requires the Authority to investigate any issue that appears to be a matter which is within the scope of its enforcement powers and which is the subject of a representation made to the Authority by a person appearing to have an interest in the matter. Under the Act and under the conditions of the licences, the Authority may require licence holders to furnish it with information.

1.13 Section 5 of the Gas Act provides that it is a criminal offence for a person to convey gas to a pipeline system operated by a gas transporter unless that person is authorised to do so by a licence. Section 5 also provides that it is a criminal offence to arrange with a gas transporter for gas to be introduced into a pipeline system operated by a gas transporter unless authorised to do so by a licence.

**Gas Transporters' Licence**

1.14 A GT has a duty, under section 9 of the Gas Act, to develop and maintain an efficient and economical pipeline system for the conveyance of gas and, so far as it is economical to do so, to comply with any reasonable request to connect to that system and convey gas by means of that system to any premises. A GT has a further duty, also under section 9 of the Act, to avoid any undue preference or discrimination in the connection of premises to any pipeline system operated by it, or in the terms on which it undertakes the conveyance of gas by means of such a system.

1.15 The GT licence places certain obligations on the GT, including the requirement that the GT introduces a network code, which sets out the arrangements between the GT and shippers for the use of, and connection to, that GT's pipeline system. All network codes are required to meet the following relevant objectives as set out in Standard Condition 9 of the GT licence:

(a) the efficient and economic operation by the licensee of its pipeline system;

(b) so far as is consistent with sub-paragraph (a), the efficient discharge of its obligation under its licence;

(c) so far as is consistent with sub-paragraphs (a) and (b), the securing of effective competition between relevant shippers and between relevant suppliers; and

(d) so far as is so consistent, the provision of reasonable economic incentives for relevant suppliers to secure that the domestic supply security standards are satisfied as respects the availability of gas to their domestic customers.

1.16 Standard Condition 4D(1) of the GT licence requires the GT to conduct its transportation business in the manner best calculated to ensure that neither the GT nor any person related to it, nor any gas shipper, obtains any unfair commercial advantage.

1.17 Standard Condition 16(2) sets out certain gas security standards to which the licensee shall plan and develop its pipeline system. This standard is such that the pipeline system can meet the peak aggregate daily demand that is only likely to be exceeded in 1 in 20 years.

*Transco's Network Code*

1.18 Transco's network code was put in place in March 1996. The mechanism for modifying the network code is set out in Standard Condition 9 of Transco's GT licence and in the network code modification rules. Under the modification rules, only shippers and Transco are able to propose modifications to the network code. Ofgem is not itself able to propose modifications, although implementation of all modifications requires the consent of the Authority.

1.19 The Authority may only direct that the network code should be modified if, in its opinion, the proposed modification would, as compared to the existing provisions of the network code or any alternative proposal, better facilitate the achievement of the relevant objectives as set out in Standard Condition 9 of the GT Licence. In making such a direction, the Authority is bound by to consider its duties and objectives under sections 4 and 4A of the Gas Act 1986.

### Gas shipper's licence

1.20 The Gas Shipper's licence includes a number of standard conditions.

1.21 Condition 3(1) requires the licensee to act in a reasonable and prudent manner in making use of the GT's pipeline for the conveyance of gas. Condition 3(2) requires that the licensee shall not knowingly or recklessly pursue any course of conduct which 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 that transporter of its system; or

(c) the due functioning of the arrangements provided for in its network code.

1.22 Thus Condition 3(2) prohibits a shipper knowingly or recklessly pursuing a course of conduct likely to prejudice the factors outlined in paragraphs 2(a), 2(b) and 2(c) of Condition 3. Ofgem considers that the reference to a 'course of conduct' implies that a series of events, not a single action, must occur for the licensee to have breached this condition. Furthermore, the prejudicial effect must be likely at the time of the conduct, not just with hindsight.

1.23 Condition 3(3) requires that the shipper 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 by the licensee on a particular day to that transporter's pipeline system.

1.24 Ofgem considers that condition 3(3) prohibits single actions, together with courses of conduct. In considering whether any shippers breach condition 3(3) by 'knowingly or recklessly' providing false information to the relevant transporter, Ofgem takes into account the range of forecasts used by shippers when making nominations and determines whether a shipper's nominations are outside any reasonable forecast.

1.25 Condition 4 relates to the policies of dominant shippers in gas markets. Condition 4(2) requires that a dominant shipper must, if requested by the

Authority, supply it with a statement of the shippers' policies as respects its participation in the gas market. Where that statement no longer adequately or accurately describes the policies to which it relates, the licensee shall as soon as is reasonably practicable give the Authority a statement of any change in those policies or of any new policies.

1.26 Condition 9 places further obligations on a licensee to provide information to a relevant transporter to enable the transporter to make plans for the safe operation of its pipeline system.

1.27 Condition 10 requires licensees to furnish the Authority with information as it may reasonably require or as may be reasonably necessary for the purpose of performing functions assigned to it by or under the Gas Act. The Authority cannot require a shipper to provide any document or record or produce any information, which a court in civil proceedings would not be able to compel the shipper to produce. All other documents must be produced even if they are subject to confidentiality provisions.

# Appendix 2 Guidance to shippers on conduct in the capacity market

17 October 2000

**BG Transco, shippers and other interested parties**

Our Ref:
Direct Dial: 5927
Email: steve.smith@ofgem.gov.uk

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 apart 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 have 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).[20] 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

[20] Prices paid by BG Transco on 12 June 2000.

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.

**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,

Steve Smith
**Director, Trading Arrangements**

3 September 2001

**Transco, shippers and other interested parties**

Direct Dial: 0207 901 7327
Email: steve.smith@ofgem.gov.uk

Dear Colleague,

**Capacity trading in the secondary and buy-back markets**

I am writing to clarify an issue that has been recently raised by some shippers seeking clarification of Ofgem's views relating to shippers selling of surplus National Transmission System (NTS) entry capacity in the secondary and buy-back markets.

A number of shippers have contacted Ofgem to ask whether it would have any regulatory concerns if shippers were to purchase surplus capacity solely for the purpose of speculative trading, with the intent of selling it back to Transco or other shippers on secondary markets at a premium. These shippers have indicated that they do not intend to utilise this capacity, merely purchase it as surplus capacity and subsequently trade it.

In general, we do not have concerns about trading of capacity by companies for whatever purpose and recognise the benefit that such trading can bring by increasing liquidity in markets. In trading capacity, shippers should ensure that their conduct is consistent with their obligations under general competition law, financial services regulation and their licences issued under the Gas Act.

I have set out, to aid companies in framing compliance programmes, Ofgem's views on certain forms of conduct that could be problematic. These examples are not new and I have written to shippers in similar terms in the past. However, as this issue has been raised by a number of shippers recently, I thought it might be helpful to re-state them.

**Nominations behaviour**

Ofgem would remind shippers that seeking to force a constraint or exacerbate an existing constraint by nominating gas flows to Transco against capacity holdings where there is no intent to flow the gas may constitute a breach of Standard Condition 2.

In this respect, we have frequently warned shippers that nominations that were likely to give a false impression as to the amount of gas to be delivered (off-taken) onto (from) the transmission system could involve a breach of Standard Condition 2(3) of the Gas Shipper's Licence.

In 1998, we initiated an investigation into shippers' nomination behaviour at the St Fergus and Bacton terminals to determine whether there was evidence of potential breaches of Standard Condition 2(3). As a result of this investigation Ofgem concluded that a number of shippers had contravened their licences.[21]

Shippers should look carefully at the conclusions of that investigation to understand in greater detail the nature of our concerns and the sorts of tests that Ofgem would apply in seeking to determine whether conduct did or did not represent a breach of licence.

**Bidding behaviour**

In its letter to shippers of 17 October 2000 Ofgem offered shippers guidance on what, in Ofgem's view, constitutes acceptable bidding behaviour in the capacity buy-back market. In this letter we indicated that prices for capacity buy-backs should reflect the opportunity costs of releasing that capacity to Transco.

In this respect, Ofgem continues to believe that, when assessing a company's conduct in the buy-back market, it is appropriate to adopt a benchmark of what we would expect to see in a competitive market. In a competitive market, Ofgem would expect to see the price at which capacity is bought back from shippers by Transco to reflect the opportunity costs to shippers of releasing capacity.

Ofgem recognises that the buy-back market is dynamic and that variations in price within day and over time are consistent with price movements in a competitive market.

Ofgem would expect that in a competitive secondary market a shipper would not be able to influence the price of capacity in secondary markets (including the buy-back market). As such if prices in the buy back market appeared not to be following a path that one might expect to see in a competitive market, reflecting movements in opportunity costs, we would take action if we believed that a company's conduct was harming competition and/or customers.

**Conclusion**

In conclusion, Ofgem does not have any general concerns regarding purchasing capacity for trading purposes and recognises the benefits that this can bring to the market through enhancing liquidity. All companies, when buying and selling capacity in secondary markets should ensure that their conduct complies with relevant legislation and regulatory obligations.

Ofgem continues to monitor the entry capacity market and shipper nominations. Ofgem will take appropriate action if it considers that a shipper is breaching its licence obligations or competition law.

I hope that this letter goes some way to clarifying Ofgem's position. Ofgem expects to shortly release the results of the capacity market investigation it initiated in October

[21] For a discussion of the investigation please see *'St Fergus and Bacton Investigation. A report under section 39(4) of the Gas Act 1986'*, Ofgem, December 1999.

2000. If you have any further queries, please do not hesitate to get in touch with me on the number above or alternatively, please call Mark Feather.

Yours sincerely,

Steve Smith

**Director, Trading Arrangements**

## Appendix 3 Ofgem information request to shippers

24 October 2000

Direct Dial : 020 -7932-5927
E-Mail :
Our Ref : JAS010_23

Shipper X

Dear X

**Information Request in accordance with Standard Condition 9 of the Gas Shippers' Licence**

I am writing to you to request information regarding capacity trades.

Ofgem is currently investigating shipper behaviour in the capacity market during the recent constraints on the National Transmission System (NTS). Therefore, the Director General of Gas Supply formally requires you pursuant to Standard Condition 9 of your Gas Shippers' licence, to furnish the following information:

i. The volume, price, location (terminal) and name of counterparty for all your capacity trades, undertaken for Gas Days 24 September 2000 to 23 October 2000 inclusive, where there was an actual transfer of monthly system entry capacity (MSEC), which were for delivery between 1 October 2000 and 23 October 2000.

Ofgem stresses that a failure to provide this information or the provision of information that is knowingly false, inaccurate or incomplete would constitute a breach of the terms of your shippers licence. Ofgem recognise that the requested data is of a highly confidential nature and will ensure the commercial confidentiality of any information provided to us.

The provision of the above information will assist us in our investigation.

We require this information in Excel format, based on the *pro form*a, as attached in the appendix of this letter, to be received at our offices by 5 p.m. on 31 October 2000. Your response should be addressed for my attention. You may provide this information either on disc or by e-mail to the following address: Desiree.Barratt@ofgem.gov.uk

If you have any queries regarding this letter, please feel free to either John Kennedy on 020 7932 5903 or Samanta Padalino on 020 7932 6393.

Yours sincerely,

Steve Smith
**Director, Trading Arrangements**

## APPENDIX

***Pro forma***

| **Gas Day*** | **Delivery Date** | **Volume** | **Price** | **Counterparty** | **Terminal** |
|---|---|---|---|---|---|
| **24/09/00** | **1/10/00** | | | | |
| | | | | | |
| | | | | | |
| **27/09/00** | **2/10/00** | | | | |
| | | | | | |
| **30/09/00** | **3/10/00** | | | | |
| | | | | | |
| **1/10/00** | “ | | | | |
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| **2/10/00** | “ | | | | |
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| | | | | | |
| **23/10/00** | **23/10/00** | | | | |

*** Date on which the trade occurred.**