

Modification proposal:	Uniform Network Code (UNC) 187/187A: Alterations to the RMSEC Auction to Accommodate Transfer and Trade of Capacity between ASEPs (UNC187/UNC187A)		
Decision:	The Authority ¹ directs that proposal UNC187A be made ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	23 April 2008	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

The 2002-2007 price control settlement placed an obligation on National Grid Gas NTS (NGG NTS) to use all reasonable endeavours to offer for sale a baseline level of capacity at each Aggregate System Entry Point (ASEP). This provided gas shippers with certainty about the minimum amount of capacity that NGG NTS would make available but did not allow for unsold capacity to be reallocated to other entry points where users value it most. Additionally, the arrangements allowed a user to trade all or part of its National Transmission System (NTS) entry capacity rights to another user at the same ASEP; however, this did not allow for trade between different ASEPs.

As part of the Transmission Price Control Review (TPCR) 2007-2012 Ofgem placed a new obligation on NGG NTS to facilitate the transfer of unsold entry capacity to meet demands for capacity elsewhere on the NTS, referred to as “transfers”. Ofgem also placed an obligation to facilitate the trade of sold capacity between entry points, referred to as “trades”. This was to guard against the risk of capacity being unused and unavailable (‘sterilised’) at an entry point where it was not needed.

Interim transfer and trade arrangements were implemented with UNC169 (Transfer and Trading of Capacity Between ASEPs)³. This followed the rejection by the Authority of a number of other proposals to introduce transfer and trade⁴. UNC169 resulted in a Transfer and Trade System Entry Capacity (TTSEC) auction on two separate days in September and October 2007 for the allocation of entry capacity in the November 2007 to March 2008 period only. This was complemented by the interim transfer and trade methodology statement which set out how the exchange rate for transfer and trade of capacity between ASEPs would be calculated in this period.

On 31 October 2007 the Authority published a direction requiring NGG NTS to have an approved enduring transfer and trade methodology statement in place by 2 June 2008. Following consultation with industry participants, this statement was submitted to Ofgem

¹ The terms ‘the Authority’, ‘Ofgem’ and ‘we’ are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ See <http://www.gasgovernance.com/NR/rdonlyres/741010D5-B22E-417E-94C9-26874FF8D5C4/19778/UNC156156A169169A.pdf>

⁴ The UNC modification proposals to introduce transfer and trade which were rejected include UNC138 (Transitional Arrangements for Entry Capacity Transfers to Sold Out ASEPs), see <http://www.gasgovernance.com/NR/rdonlyres/7C6E3EAD-08B0-4FFD-856B-6C1166D11054/16968/OfgemDecisionLetter.pdf>; UNC150 (Introduction of the AMTSEC Auction), UNC150A (Introduction of Unsold Entry Capacity Transfers), see <http://www.gasgovernance.com/NR/rdonlyres/219A4091-B771-4BBB-A16E-E3355EE2F32D/17679/01500150AOfgemDecisionLetter.pdf>; UNC151/UNC151A (Transfer of Sold Capacity Between ASEPs), see <http://www.gasgovernance.com/NR/rdonlyres/A27A4944-5214-4C79-B01D-AEE38305EEA1/17680/01510151AOfgemDecisionLetter.pdf>; UNC156/UNC156A/UNC169A (Transfer and Trading of Capacity Between ASEPs), See footnote 3.

for approval on 22 February 2008. The statement sets out operational rules for deriving ex-post exchange rates for transfers or trades of entry capacity between ASEPs and is intended to be complementary to the modification proposals considered in this letter, which seek to facilitate the transfer and trade of entry capacity. Yesterday we published a separate letter approving this statement.

To comply with its licence obligation to meet requests for the transfer and trade of capacity between ASEPs NGG NTS has presented Ofgem with a proposal for enduring arrangements for the transfer and trade processes, UNC187. This proposal has attracted a variant proposal UNC187A. These two proposals are discussed below.

The modification proposals

UNC187: Alterations to the RMSEC Auction to Accommodate Transfer and Trade of Capacity between ASEPs

NGG NTS proposes adding a mechanism for transfer and trade of entry capacity onto the existing Rolling Monthly System Entry Capacity (RMSEC) auctions. The RMSEC auction would continue as a pay-as-bid auction but with the following revised process:

- NGG NTS invites users to surrender entry capacity
- Users wishing to offer to trade capacity which they already hold notify NGG NTS of the maximum amount of capacity they are willing to surrender, at which ASEP along with a minimum, or surrender⁵, price it is willing to accept
- NGG NTS invites users to make bids for entry capacity
- Users make bids in the auction

Following receipt of the bids NGG NTS allocates the capacity in two stages.

Initial Stage

Allocations are first made at each ASEP on the basis of the highest bid first, with allocations made on a pro-rata basis for equal priced bids. The capacity to satisfy each bid comes first from surrendered capacity before unsold capacity. The surrendered capacity is re-allocated on the basis of highest surrender price first. In the case of equal surrender prices the capacity is re-allocated on a pro-rata basis.

Any unsatisfied bids plus the remainder of any partially satisfied bids pass through to the next, Transfer and Trade, Stage. All available capacity unallocated in the Initial Stage is made available to meet requirements of the remaining unsatisfied bids.

Transfer and Trade Stage

The remaining unsatisfied bids from the Initial Stage for each recipient ASEP⁶ are put into four groups equal by volume⁷ with highest priced bids in the highest ranking group. All the groups across all the ASEPs are ranked according to Weighted Average Price⁸. Where a recipient ASEP appears successively in the ranking the successive groups are merged.

⁵ The surrender price shall not be greater than the prevailing reserve price.

⁶ Recipient ASEPs are defined as where there are unsatisfied bids after the Initial Stage.

⁷ Where equally priced bids or a single bid span a group threshold all such bids are included in the highest group and the size of the next group down is reduced accordingly.

⁸ Equal Weighted Average Prices are ranked in order of (i) highest individual bid in the group, then by (ii) quantity of bid capacity in the group, then by (iii) time stamp on the first bid

Allocation is then made first for the highest ranked group. For this group donor ASEPs⁹ are ranked according to how favourable the exchange rate is, as calculated by the enduring entry capacity transfer and trade methodology. Capacity is relocated from highest ranked donor ASEP until all possible capacity is allocated¹⁰, then the next most favourable donor ASEP is considered. If all the bids in the group cannot be satisfied then allocations are made in bid price order (then by time for equal priced bids). If some bids are still unsatisfied after all donor ASEPs have been considered then the remaining unsatisfied bids are considered with the next ranked group for that particular ASEP. This process is then repeated for the next ranked group.

This is subject to the surrender price being less than or equal to the unit price¹¹. In providing capacity for each allocation surrendered capacity is allocated before unsold capacity at each donor ASEP. Surrendered capacity is allocated on the basis of highest surrender price first.

The recipient user pays NGG NTS the bid price for the capacity. In the case of surrendered capacity the surrendering user is still liable for the capacity charges to NGG NTS. However, NGG NTS pays the surrendering user the weighted average unit price.

Exchange rates are capped at 10:1.

UNC187A: Alteration to the RMSEC Auction to Accommodate Transfer and Trade of Capacity Between ASEPs

British Gas Trading proposes UNC187A which is similar to UNC187 except that:

- The surrender price does not have to be less than or equal to the reserve price
- Capacity is allocated from a donor ASEP in the following order, for both Initial and Transfer and Trade stages:
 - i. Surrendered capacity with surrender price less than or equal to reserve price (in order of price with lowest surrender price first¹²)
 - ii. Unsold capacity
 - iii. Surrendered capacity with surrender price greater than reserve price (in order of price with lowest surrender price first¹³)

UNC Panel¹⁴ recommendation

At the modification panel meeting held on 21 February 2008, of the 10 voting members present, capable of casting 10 votes, 9 votes were in favour of implementing UNC187 and 7 votes were in favour of implementing UNC187A. The Panel therefore recommended implementing both proposals.

At the same meeting the Panel voted for the proposal which would better facilitate the relevant objectives. Of the 10 voting members present, capable of casting 10 votes, 7 votes were cast in favour of implementing UNC187 in preference to UNC187A and 1 vote

⁹ A donor ASEP is where there were no unsatisfied bids after the Initial Stage and where there remains available capacity.

¹⁰ NGG may recalculate the exchange rates afterwards and re-order the remaining Donor ASEPs

¹¹ $Unit\ Price = Bid\ Price + Exchange\ Rate$

¹² Pro-rated for equal surrender prices

¹³ Pro-rated for equal surrender prices

¹⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

was cast in favour of implementing UNC187A in preference to UNC187. Therefore the Panel considered that of the two proposals UNC187 would better facilitate the achievement of the relevant objectives, although no specific reasons for this preference have been noted in either the Final Modification Report or the Panel meeting minutes.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 April 2008. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR¹⁵. The Authority has concluded that:

- 1. implementation of the modification proposals UNC187 and UNC187A will better facilitate the achievement of the relevant objectives of the UNC¹⁶;**
- 2. of these proposals, UNC187A best meets the relevant objectives of the UNC; and**
- 3. directing that the modification UNC187A be made is consistent with the Authority's principal objective and statutory duties¹⁷.**

Reasons for the Authority's decision

The efficient and economic operation of the pipe-line system to which this licence relates

Respondents indicated that there was a trade off between obtaining greater transparency with ex-ante exchange rates and the possibility of greater capacity being made available with ex-post exchange rates. One respondent favoured ex-ante exchange rates whilst another considered ex-post exchange rates were appropriate subject to suitable scrutiny of how the exchange rate was calculated.

From the consultation one response thought a cap on exchange rates was appropriate to avoid excess capacity destruction, though it sought clarity on what an appropriate cap could be.

One respondent stated that incorporating transfer and trade into the RMSEC auction allows shippers to optimise capacity bookings closer to when they will use the capacity. Another considered that holding transfer and trade allocations on a monthly basis gives greater certainty which could encourage greater surrender of capacity, though it noted that holding the RMSEC auctions earlier in the month would reduce some of this certainty.

Another argued that UNC187 encourages shippers holding capacity of no value to them to surrender it at the reserve price which does not reflect its true value. Two respondents considered that having no cap on the reserve price, as in UNC187A, will result in less limited movement of capacity.

¹⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

¹⁶ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

¹⁷The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

One response considered that matching the highest bid price with the highest surrender price, as in UNC187, is more efficient than matching it to the lowest surrender price, as in UNC187A. However, another respondent thought the opposite was true.

Six respondents favoured the allocation of surrendered capacity ahead of unsold, as in UNC187, as this would maximise the quantity of unsold capacity available in the daily auctions.

Concerns were raised by one respondent that the risks of higher operational buy-back costs with both proposals could outweigh benefits.

According to NGG NTS, the use of ex-post exchange rates, as distinct from ex-ante rates as used in the interim methodology, should allow for less conservative exchange rates to be applied. Ofgem accepts that as a result of ex-post exchange rates NGG NTS would face considerably less risk compared with ex-ante exchange rates. We would therefore expect to see significantly greater amounts of capacity transferred and traded, as NGG NTS argued workstream meetings. However, we still consider that the use of ex-post exchange rates provides less certainty for shippers who are submitting capacity to be traded and we still think that this is undesirable. But the application of a shipper-specified surrender price in both UNC187 and UNC187A should go some way to mitigating this concern by giving shippers certainty on the minimum value they obtain for surrendered capacity. The Proposals also contain significant information release provisions after the allocations have been made, and this should allow shippers to be able to anticipate the likely ranges for exchange rates between ASEPs over the longer term.

We consider that adding the transfer and trade process to the existing monthly RMSEC auctions allows shippers to have much greater certainty over their capacity requirements for the following month which should encourage both surrender of and bids for capacity.

We also think that UNC187A is preferable to UNC 187 as it does not place any restriction on the surrender prices. In particular, the absence of any restrictions on surrender prices should encourage more shippers to offer to surrender their capacity and allow more transfer and trades to take place when the system is constrained. There may, for example, be occasions when the value of capacity at an entry point is above the reserve price (as there is a constraint) but that there are shippers who value that capacity even more at other entry points. Capping the surrender price could prevent efficient transfers that benefit both shippers from taking place. Of the two proposals, UNC187A should therefore result in less sterilised capacity and facilitate the efficient and economic operation of the NTS.

So far is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence

Ofgem considers that both UNC187 and UNC187A should constitute an efficient discharge of NGG NTS's licence conditions, Special Conditions C8D(11) and C8D(12). Both proposals allow for shippers to express their requirement for capacity through the altered RMSEC auction process and allow NGG NTS to respond to this by calculating exchange rates and enacting capacity transfers and trades, where appropriate.

So far is consistent with sub-paragraphs (a) to (c) the securing of effective competition (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators

Two respondents thought that the Initial Stage gives the incumbent at that ASEP a significant advantage, with one adding that this would result in the market price for that capacity not being reflected in the outcome of the process. However, another three respondents thought it advantageous for shippers to be able to get capacity at an ASEP before any transfer or trade.

Another welcomed the ability for surrendering users to specify a minimum surrender price which it considered removes a barrier to participation. However, it noted that as the reserve price acts as a cap on the surrender price in UNC187 then this acts as a partial barrier. Two respondents noted that the surrender price cap avoids the capacity price on the network being dictated by where a constraint exists.

Four respondents considered that UNC187A would encourage speculative behaviour. Two of these added that larger users could buy lots of cheap capacity to sell at higher prices elsewhere which was considered to be a barrier to entry and anti-competitive. Another respondent argued that concerns over abuse of pricing in UNC187A are mitigated by the surrendering user not knowing the exchange rate in advance.

We consider that allocating capacity at each ASEP during the Initial Stage prior to initiating the Transfer and Trade Stage has the benefit of minimising capacity degradation. We considered it inappropriate to have capacity preferentially allocated to each ASEP first with modification proposal UNC169A as this was a one-off auction dedicated to transfer and trade whereas UNC187 and UNC187A incorporate the transfer and trade processes into existing RMSEC auctions.

Ofgem agrees with one of the respondents that the use of a surrender price in both modification proposals should remove a barrier to shippers participating in the surrender, and therefore trade, of capacity. Furthermore, we consider that having a limit on the surrender price, as in UNC187, could introduce the potential for a barrier to trading for those shippers who value their capacity more than the reserve price. Therefore, our view is that UNC187A, with no limit on the surrender price, should have fewer barriers to surrendering and trading capacity. This should secure effective competition to a greater extent between shippers than with UNC187.

Ofgem does not share the concerns expressed about the potential for speculative behaviour. Non physical players who buy capacity for speculative purposes bring liquidity and depth to the market. There are also effective anti-hoarding mechanisms in place through use-it-or-lose it arrangements to guard against hoarding by any capacity holder.

Both modification proposals would further the relevant objectives of economic and efficient operation of the NTS, efficient discharge of NGG NTS's licence and securing of effective competition between shippers. However, our view is that the economic and efficient operation of the NTS and securing of effective competition between shippers would be better furthered by implementation of UNC187A because it does not limit or constrain the prices that shippers can offer to surrender capacity.



Steve Smith

Managing Director, Networks

Signed on behalf of the Authority and authorised for that purpose.