

OFGEM DECISION LETTER No. 0623
"Modification to LTSEC Weak Closure Rule"
Version 1.0

Transco, Shippers and other parties

Dear Colleague,

Network Code Modification Proposal 623: Modification to LTSEC Weak Closure Rule.

Transco raised network code modification proposal 623, '*Modification to LTSEC Weak Closure Rule*', on 16 May 2003. Ofgem has considered the issues raised in this modification proposal, and has directed Transco to implement this proposal, because we believe that it will better facilitate the relevant objectives of Transco's network code. We have set out our reasons for making this decision below.

Further information on this issue can be found in Ofgem's document, 'The January 2003 Long-Term Entry Capacity Auctions – A Review Document', which was published by Ofgem on 21 August 2003.

Background to the proposal

The recent Long Term System Entry Capacity Auctions, held in January 2003, highlighted some inefficiencies in the process currently being used. As a result of this, and following discussions within the NT&T workstream, it was decided to raise a modification proposal which would address these inefficiencies and improve the LTSEC process.

The Modification Proposal

This modification proposal has three elements:

- 1) A change to the notional clearing price applicable in the long-term auctions to the step price level at which aggregate demand is first less than or equal to notional supply at that step price level.
- 2) A renaming of the 'prevailing step price group' to 'stability group'.
- 3) Strengthening the auction closure rule so that the auction would close before the end of the tenth bidding day if the stability group changes in fewer than five individual quarter/terminal combinations over two consecutive bidding days.

While the proposed implementation date for the first two aspects of the proposal is 1 August 2003, in its revised final modification report Transco proposed an implementation date for the third aspect of the proposal of 1 November 2003.

Respondents' views

There were 11 responses to this modification proposal. Respondents generally commented separately on the three aspects of the proposal.

1) Change to the notional clearing price

There was unanimous support for this element of the proposal, with most respondents of the view that the proposed change to the notional clearing price methodology would be in line with how shippers expected the notional clearing price to be calculated and that the proposed change would provide welcome clarification to the rules. A number of respondents also stated that the proposed change in itself may contribute to an early closure of the auction, because the notional clearing price would be less susceptible to small changes in demand.

2) Renaming of the 'prevailing step price group'

There was general support for this element of the proposal, which was viewed as uncontroversial.

3) Strengthening of the auction closure rule

Respondents were fairly evenly divided on this aspect of Transco's proposal, with a slight majority supporting, or giving qualified support.

Respondents supporting the proposed strengthening of the closure rule considered that it would encourage more accurate and timely bidding and could be expected to reduce the number of auction rounds. These respondents considered that the proposal was not too dramatic a change as to undermine the auction; while those who qualified their support of the proposal considered that it did not go far enough.

A number of respondents did not support this aspect of the proposal and considered that the issue should be considered more fully, particularly given that it was not possible to implement this aspect of the proposal in time for the next long-term auctions. A number of respondents were against implementing a number of changes to the closure rule concurrently, and considered that it would be preferable to implement the first aspect of this proposal only. They considered that this would allow shippers to better predict the closure mechanism and enable assessment of the effect of the change.

One respondent opposed strengthening the closure rule in the manner proposed by Transco and did not want the auction to close before users have had an opportunity to adequately explore the impact of the variability in their demand on total demand. This respondent considered that four quarter/terminal combinations in practice is likely to be a significant proportion of the quarter/terminals at which there is potential change in the 'stability group'.

Transco's views

Transco considered that it was appropriate to respond to shippers' concerns about the closure rule and also considered that the balance of shipper opinion supported strengthening the closure rule. Transco considered that improving the clarity of the auction closure rules and strengthening the closure rule would better facilitate a more efficient auction process, which might be expected to better facilitate competition between shippers.

Transco identified advantages of this proposal as providing greater clarity to shippers and stronger incentives on shippers to bid accurate requirements early in the auction process. It considered that disadvantages of the proposal were that it introduces possible uncertainty about how strengthened gate closure rules impinge on bidding strategies and that a stronger gate closure rule would tend to reduce the opportunities for revising bids.

Change to the notional clearing price

Transco considered that it is desirable to provide clear definitions in its network code.

Renaming of the 'prevailing step price group'

Transco considered that the name change should serve to provide further clarity about the purpose of the prices which are published during the auction process.

Strengthening of the auction closure rule

Transco considered that the proposed change should encourage shippers to bid their 'true' requirements early in the process and that a level of uncertainty as to when the auction would close is necessary for this to occur. While Transco noted that the shipper licence requires that misleading information should not be passed to the gas transporter, it considered that there is benefit from network code changes that could further improve the auction process.

Transco considered that the proposed choice of four terminal/quarter combinations was a pragmatic first step in improving the auction rules and considered that it was unclear what type of analysis could be conducted to determine ex ante what the 'correct' number would be.

Ofgem's views

As a general principle, Ofgem considers that changes to the auction rules should not be made unless they clearly have a beneficial effect and the change is supported by robust analysis. It is therefore unhelpful to combine two proposed changes to the auction rules in one modification proposal.

Ofgem would encourage network code participants considering raising proposals to change the auction rules in future to confine their proposals to single changes to the auction rules, in order to allow a consideration of each proposed change to the auction rules on its merits alone.

Ofgem agrees with the point made by a number of respondents that the proposal to strengthen the closure rule should have been considered more fully, particularly given that Transco has stated that it is not possible to implement this aspect of the proposal in time for the next long-term auctions.

Notwithstanding these reservations, Ofgem is required to make a decision on each proposal to modify Transco's network code against the relevant objectives and our reasons for decision are set out below.

Change to the notional clearing price

Ofgem welcomes this aspect of the proposal, which would change the methodology used to determine the 'notional clearing price' to one which is understood by shippers. There was

confusion during the first long-term auctions over the methodology used and Ofgem would encourage Transco to provide clear and detailed information, including numerical examples in the form of spreadsheets, explaining the methodology to shippers in advance of the next long-term auctions.

Ofgem considers that this aspect of the proposal would facilitate the securing of effective competition between relevant shippers, through a better understanding of the auction process.

Renaming of the 'prevailing step price group'

Ofgem welcomes this aspect of the proposal to the extent that it also improves shipper understanding of the notional clearing price or 'stability' concept.

Strengthening of the auction closure rule

Ofgem notes that opinion on this aspect of Transco's proposal was more divided than the first two aspects of the proposal. While the closure rule remains a 'weak' closure rule, by strengthening the early closure rule and making it more likely that the auction will close before the end of the tenth bidding day, this should encourage shippers to place early bids which reflect their genuine demand.

However, Ofgem is concerned that this element of the proposal has not been properly developed and is not supported by robust analysis. There is a danger, highlighted by one respondent, that this element of the proposal may result in the auction closing prematurely, when clearing prices at a number of ASEP/quarter combinations are still adjusting. This may lead to inefficient allocations and auction signals.

Ofgem notes that Transco's proposed implementation date of November 2003 would mean that the change would not be implemented for the forthcoming long-term auctions in September 2003. On balance, while this change may reduce the extent to which shippers are able to revise their bids during the auction process, Ofgem considers that the potential adverse effect is limited because it would only affect four or less ASEP/quarter combinations.

Ofgem's decision

Considering the two main aspects of this proposal as a whole, Ofgem considers that the potential dangers with the strengthening of the closure rule are outweighed by the positive effects of the change to the methodology for the calculation of the 'stability measure'. In particular, we consider that the proposal as a whole better facilitates the securing of effective competition between shippers by improving the efficiency of the auction process. For the reasons given above, Ofgem has decided to approve this modification.

However, as stated above, Ofgem does have some reservations about strengthening the closure rule and given Transco's delayed implementation date for this element of the proposal, it is open to any network code signatory opposed to this aspect of the proposal to raise a modification proposal to prevent the application of this change to the auction rules. Such a modification proposal could facilitate a more informed analysis of the effects of a strengthened closure rule.

Yours sincerely

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