

# **TRANSCO CONSULTATION REPORT ON PC51**

## **Determination of Daily System Entry Capacity Floor Prices**

### **1. Transco's Initial Proposal**

Transco proposed that Daily System Entry Capacity should have a floor price set at 1.25 times the weighted average (by volume) price in the relevant auction of Monthly System Entry Capacity (MSEC). The present multiple is 1.5. The proposal is dependent upon approval of Network Code Modification Proposal 0365, which seeks to establish a within day capacity mechanism for entry capacity.

### **2. Summary**

In total there were fourteen responses. A number of respondents wished to make clear that their responses to this pricing consultation did not signify agreement with Network Code Modification Proposal 0365. In particular a number of respondents expressed concern regarding the possibility of restricting provision of Interruptible System Entry Capacity if a within day capacity mechanism is established. Transco recognise shipper concerns and wish to reassure all respondents that they have an opportunity to comment directly regarding the provision of interruptible capacity and the proposals for a within day mechanism. The close out date for consultation on Modification Proposal 0365 is 18th February.

### **3. Summary of responses**

#### **3.1 Floor price multiple**

##### **Comments Received**

Of those respondents that offered an alternative multiple, eight suggested one, two respondents suggested 1.1, one respondent suggested 1.01 and one respondent suggested a multiple of 0.8. Not all respondents agreed that the multiple should be applied to a weighted average of the top 50% of accepted bids in the relevant auction of MSEC. Four respondents believed that it would be more appropriate to apply the multiple to the weighted average price of all accepted bids. In three cases the respondents had proposed a multiple of one and in the fourth case a multiple of 0.8 was suggested. One respondent had suggested that a multiple of 1.01 times the floor price established for auctions of MSEC would be appropriate whilst another respondent had suggested a multiple of one times the floor price for MSEC.

##### **Transco's Response**

The proposal is made such that incentives are maintained for MSEC to remain the primary source of entry capacity, while it is believed that a reduction in the floor price multiplier will better facilitate the efficient clearing of daily and within day capacity auctions. In addition, the proposed methodology change will enable Transco to take account of developments in the transportation business as required in Standard Condition 4c of its Public Gas Transporter Licence. In particular, the developments are a proposed reduction in quantities of Interruptible System Entry Capacity, that form part of the proposals for implementation of a within day capacity mechanism. If a within day mechanism is introduced without an accompanying reduction in floor prices

then income from sales of daily capacity could increase. Consequently, this pricing proposal is dependant upon implementation of Modification 0365.

Much of the debate regarding floor price multiples hinges upon an assessment of the magnitude of floor price that is required to maintain a satisfactory incentive to book monthly capacity. Respondents have been unanimous in arguing that floor prices for daily capacity should be reduced further than the levels proposed in PC51 whilst maintaining a satisfactory incentive to buy the monthly capacity. A supporting argument for this view is shippers desire for a degree of certainty prior to planning gas supply profiles. Further benefits of holding monthly capacity also accrue through the smear back of revenues from the sale of daily capacity which can reduce the effective cost of monthly capacity.

Transco is of the opinion that applying the multiple to a weighted average of the top 50% of accepted bids in the relevant MSEC auction is a necessary component of Daily System Entry Capacity floor prices. It is also desirable to maintain a consistent floor price methodology for all entry capacity charges. In this respect the weighted average of the top 50% of accepted bids is also used in floor price calculations for Unsold Long Term Firm and Interruptible System Entry Capacity.

Regarding the precise multiple, be it 1.25 or one times the weighted average of the top 50% of all accepted bids, Transco agrees with a number of respondents in their assertion that the chosen multiple is to a certain extent an arbitrary choice. Transco recognise that it may be possible to reduce the floor price multiple further in a manner that does not undermine the incentives to book monthly capacity whilst further enabling an efficient clearing of daily capacity auctions.

### **3.2 Implementation date Comments Received**

Two respondents requested clarification of the date when the proposed new floor prices would become effective. Three other respondents suggested that implementation of the pricing proposal should not be dependent upon the progress of Modification Proposal 0365.

#### **Transco's Response**

Transco has put forward this pricing consultation to offset the impact upon entry costs of a possible restriction of Interruptible System Entry Capacity. That restriction is a consequence of the proposals contained in Modification 0365. If that Modification Proposal is not implemented, then Transco would not wish to implement the proposals contained in this pricing consultation report.

The development programme for the within day capacity mechanism has slipped from an original implementation date of 1st April to 1st June. It is not anticipated that there will be any further slippage in the development programme. In order to meet the implementation date it is assumed that Ofgem will waive normal requirements for a two month period between approval and implementation of a Modification. The proposed floor prices would, if the proposals are not vetoed, become effective on 1st June to coincide with the commencement of the within day capacity mechanism.

### **3.3 Different prices on the day**

#### **Comments Received**

One respondent requested confirmation that the proposed floor prices would be the same at an Aggregate System Entry Point at both the day ahead and within day auctions. Two respondents suggested that the floor price within day should be at a discount to the price applicable to the day ahead auction because there would be greater uncertainty that capacity could be obtained within day.

#### **Transco's Response**

Transco can confirm that the proposed floor prices would apply for all auctions of Daily System Entry Capacity regardless of whether the auction is held on or before the gas day. Maintaining the same floor price for within day and day ahead auctions will allow shippers to make an economic decision of when is the most suitable time for them to purchase capacity. The levels of risk associated with purchasing capacity at different times will, it is expected, be factored into bids.

### **3.4 Pay as Bid Auction**

#### **Comments Received**

One respondent requested clarification regarding the type of auction that is proposed for allocation of capacity in the within day mechanism. Another respondent noted that a pay as bid auction may yield a greater income which in turn would offer scope for a further reduction in the floor price multiple.

#### **Transco's Response**

Modification Proposal 0365 proposes that auctions of daily capacity should be changed from a cleared price to pay as bid type auction. Transco accepts that a pay as bid auction may increase income when compared with a cleared price auction. However, the average price above the floor price is impossible to determine before the event. Any such comparison of cleared price against pay as bid is further complicated by proposals outlined in Modification Proposal 0380 to increase the quantities of monthly capacity offered through auction to Seasonal Normal Demand plus 10%. That proposal may change shippers perspective of both the need for daily capacity and their probability of gaining any such capacity at differing price levels and hence is expected to change bidding behaviour.

### **3.5 Buy back**

#### **Comments Received**

One respondent noted that the present incentive mechanism was established in the expectation that Transco would, on occasion, be required to buy back capacity. It went on to suggest that the low risk of buy back was sufficient pretext for further reductions in daily floor prices to redress the balance of risk and reward.

#### **Transco's Response**

As noted earlier, Modification Proposal 0380 proposes that the quantities of monthly capacity offered should be increased by 10%. This proposal will increase the probability

of buy back of firm entry capacity and is considered to be the appropriate response to any perceived misalignment of risk and reward in the capacity incentive mechanism.

**3.6 Secondary markets  
Comments Received**

One respondents expressed concern that the proposal is based on an assumption that an efficient secondary market exists for entry capacity.

**Transco's Response**

Transco is unable to accurately gauge the efficiency of the secondary market for entry capacity. Consequently Transco would be interested to hear from respondents of any insights or analysis they may be able to offer regarding the efficiency of the secondary market for entry capacity.

**3.7 Interruptible capacity  
Comments Received**

A number of respondents disagreed with Transco's description of daily interruptible capacity as an insurance product. In particular the assertion that only 3% was used to flow gas was questioned. It has been suggested that shippers may also hold additional capacity for contingency purposes, to support physical system buys on the OCM and because secondary markets are not efficient.

**Transco's Response**

Transco have sought to identify how much of the interruptible capacity bought by shippers is actually required to flow gas without incurring overruns. That analysis suggests that a large proportion is bought but remains unused. Of particular importance to this aspect of the analysis are the assumptions regarding efficiency of secondary markets, which in the main the same respondents have questioned. Transco accepts that it does not have comprehensive knowledge of these aspects of daily capacity markets and would welcome any further analysis that respondents may be able to offer. It is anticipated that a within day mechanism will mitigate against shipper requirements to hold large quantities of capacity for contingency purposes. Transco accept that it is beneficial for shippers to hold capacity to support system buys on the OCM and that Modification Proposal 0365 should accommodate this requirement.

**4. Final Proposals**

**Taking into account the views of respondents, Transco propose the following modifications to the charging methodology to apply if and when Network Code Modification Proposal 0365 is implemented**

**Auctions of daily firm capacity shall have a floor price multiple of 1.0 times the average of the top 50% by volume of accepted bids in the relevant auction of monthly capacity.**