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Use of Long-term Auctions for Network Investment

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Abstract

Short-term auctions for access to entry terminals of the British gas-network appear to successfully allocate scarce resources and capture scarcity rent. Now long-term auctions are being introduced to guide future capacity expansion decisions. In our model the fraction of rights issued in the long-term auction turns out to be a crucial design parameter. Even a 'hypothetically' optimal parameter choice can in general only satisfy one of three aims: Unbiased provision of capacity, full revelation of private information and minimisation of distortions from network effects. The results suggest that long-term auctions for transmission capacity are not necessarily preferable to regulatory approved capacity expansion.

JEL; D44, L95, L5, D92.

Keywords: Auctions, Gas, Investment, Networks, Regulation.

1 Introduction

Auctions are a common method of rationing fixed and scarce resources. Their use as a means of determining and allocating future demands is a relatively new idea, however. McCabe et al. [11] anticipate the notion that auctions might successfully allocate rights

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to future network access and, in both electricity and gas there is discussion of and planning towards the use of auctions for guiding capacity investments. Within Great Britain auctions have been used since September 1999 to ration entry rights to the national gas transmission system. The electricity and gas regulator, Ofgem, has now proposed that future investments in the network be driven by the outcomes of longer term access auctions.

Within the context of auction theory entry rights to the gas network is a multi-unit product for which bidders have multi-unit demands and affiliated values. In such an environment efficiency and revenue maximization often do not coincide. Dasgupta and Maskin [6] derive strict conditions under which efficient allocations can be achieved in this setting if one allows bids to be contingent on the bids of others. However, Jehiel and Moldovanu [7] show that efficient multi-object auctions with common values do not exist in general. Efficiency can only prove more elusive if the bidding environment is extended to include future demands.

McDaniel and Neuhoff [12] discuss changes in the access regime to the National Transmission System (NTS) and the use of short term auctions for entry capacity.[1] They conclude that the short term auctions have so far been successful with respect to a number of metrics including: anticipation of spot prices, reduction of constraint alleviation costs, and rent capture. In this paper our focus will be on the long run aspects of the auction approach. Investment decisions in vertically disintegrated network industries are based on imperfect decentralized information. An objective of the auction would be to aggregate the individual demands and private information of bidders so that the network owner can make better predictions about the need for capacity upgrades to the network. At the same time, there remains the objective of ensuring sufficient competition in gas spot markets. Our results show that these objectives interact with the product being auctioned in such a way that both cannot simultaneously be achieved. The results can be directly transferred to questions of capacity expansion in electricity networks, which were previously performed by regulated monopolies, potentially based on market signals as suggested by Rivier [18] or Leautier [10]. Bushnell and Stoft [5] show that in a competitive environment tradable congestion contracts can provide sufficient incentives for investment. Our analysis suggests that for a non-meshed network market power can significantly distort capacity investment. This is empirically supported by Abdala and Chambouleyron [1] and Anderson [2], showing that irrespective of the positive framework no significant investment in transmission networks had been performed in Argentina, to our knowledge the only country that had implemented private grid capacity expansion by 1999.

This remainder of this paper is organized as follows: section two discusses the framework for our model beginning with a description of the NTS; section three presents the model

[1] A good summary of the early evolution is given by Armstrong, Cowan and Vickers [3].

and discusses the potential consequences from the use of long-term auctions, and section four concludes.

2 Framework

2.1 The gas pipeline network

Figure 1 illustrates the main gas pipeline network in Northern Europe. Most underwater pipelines start from gas fields and transport gas of different consistencies that has to be processed at the beach before it can be inserted to the National Transmission Network. The UK is responsible for 55% percent of North Sea gas production that can be roughly classified as wet and dry gas fields. Wet-gas is produced in the Northern fields that are interconnected to St. Fergus, and can be considered a by-product of crude oil production. Therefore producers do not appreciate adjusting the output to match demand. The other fields are dry-gas fields, which only produce natural gas, and can therefore be adjusted better to accommodate seasonal variations in gas demand.

The Frigg pipeline was initially constructed to allow gas from the UK-Norwegian Frigg field to be transported to the UK. The Frigg Treaty of 1997 allowed the usage of the pipeline to import gas into the UK from additional Norwegian gas fields by interconnecting it with other pipelines and using it for new gas exploration.

The UK-Belgium interconnector, opened in October 1998, was initially planned to allow for exports of UK gas to the continent, but is also used on so-called reverse flows for imports into the UK during winter peak demand. Upgrades of compression facilities are planned for 2002 to increase the reverse flow capacity. Two further interconnectors are used for exports to Ireland. Given the level of abstraction of the current study, we simply classify them as additional demand on the NTS.

There are six major beach terminals in Great Britain where gas is put into the NTS. Five of these terminals are on the east-coast: St. Fergus, Teeside, Easington, Theddlethorpe and Bacton; the last, Barrow is on the west-coast. St. Fergus in Scotland and Bacton in the south-east are the most used entry terminals on the network. The importance of St. Fergus is can be seen by observing the number of gas pipelines flowing from there into the North Sea. Bacton is likewise connected to a number of major pipelines, but more importantly, it is the closest terminal to the interconnector linking Great Britain to the continent via Zeebrugge in Belgium. The auctions for short-term rights to enter gas onto the NTS began in September 1999 and originally only included these six beach terminals.

Figure 1: Gas Pipelines Northern Europe (Copyright Platts, 2001)

The subsequent auctions also included a number of onshore fields, storage and constrained LGN facilities.

The NTS in the UK connects the gas landing facilities and storage facilities to gas customers. Demand for transmission services is volatile over the year and capacity is capital intensive making it inefficient to provide for a network that can satisfy all transmission requests. Over the last years landing gas at the St. Fergus terminal in Scotland was the most constrained, with currently binding constraints in Scotland at Aberdeen, Moffat & Woller and Kirriemiur.

2.2 Existence of Market Power

Figure 2 shows the distribution of gas production among major players. The figure suggests that overall concentration is not too high, but Transco documents indicate that several terminals on the network are only used by a small number of producers (the extreme case being at Barrow where there is essentially only one producer buying capacity rights). Consultation document PC48 shows 5-firm concentration ratios between 65-100 percent from July 1998 to June 1999.[2]

[2]Transco Revised Consultation Report on PC48, Methodology for determining floor prices for auctions of monthly entry capacity, Transco Plc. September 1999.

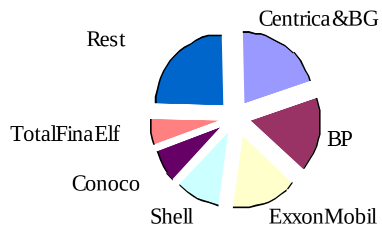

Figure 2: Share of UK gas production (Source: Leading UK Gas Producers, Platts 1998)

The concern about the effect of market power in the upstream market is mirrored in a recent consultation document by the Department of Trade and Industry. The first issue to be addressed was whether "upstream mergers have resulted in over-concentration of gas ownership."[15] In our model we assume some market power in production.

2.3 Capacity allocated in long-term auction and market entry

We assume that a proportion of transmission capacity is to be withheld from the long-term auction and allocated in spot markets. The initial purpose of retaining capacity rights for the spot market is the creation of a liquid short-term market and to ensure that entrants can obtain access rights at the market clearing price. Entry requires spot markets because few entrants would have funds to endure seven years from the long-term auction until they can deliver the first gas. Analysis of competition in the electricity industry by Newbery [14] showed that entry and the threat of entry are essential to prevent high prices. In the long-term auction this would imply that additional firms will register to participate if they anticipate that the value of the capacity contracts they obtain will be above the spot price. In a world with perfect information, no uncertainty and without transaction costs this process would mitigate market power and reduce the inefficiency of the auction signal.

Ofgem proposed that Transco provide sufficient capacity such that 25 percent of total access rights will be auctioned in the spot market.[3] We will refer to annual, monthly and daily auctions as spot markets in contrast to the long-term auction with a suggested seven year horizon. Our model shows that the proportion of capacity reserved for the spot-market has significant implications for efficiency. Threat of entry might increase efficiency, but entrants face two obstacles. First, entry is difficult if a seven-year horizon

[3] *Long term signals and incentives for investment in transmission capacity on Transco's National Transmission System*, March 2001.

is required before the first payback on investments can be expected. This difficulty will be reflected in high capital costs or in difficulty ensuring the guarantees required when signing long-term contracts. Second, entrants have less information about the market situation than incumbents. They have less information about which capacity rights are profitable to obtain and which are not. Entrants are therefore more cautious in participating in long-term auctions than incumbents that behave competitively. We assume there is a fixed cost required for any participant to acquire information and maintain the trading capabilities to participate in long-term auctions. This effectively limits the number of shippers using the network and prevents only a theoretically feasible perfect arbitrage.[4]

The assumption of capacity allocation in the spot market makes possible a liquid spot market for transmission rights allowing any shipper to obtain transmission rights at the market-clearing price. All shippers will value the rights they purchased in the long-term market at the price they could obtain in the spot market. Shippers with long-term contracts are more detached from capacity spot prices; however, if significant trading volume is performed in the spot market, then all shippers will set prices in the downstream market corresponding to spot prices irrespective of their forward contracts. Hence all shippers will include transmission at the spot market-clearing price into the resale price.

A similar situation can be observed in the international oil market. "Transnationals" like BP-Amoco and Mobil (though not Exxon) are known to hedge prices of both their crude supplies and petroleum products. The system enables petroleum companies to predict and ensure refinery margins for the year ahead"[5]. Irrespective of the hedging strategy the firms will trade petroleum products corresponding to the spot market price. BP will sell gasoline at the same price as Exxon, irrespective of Mobile's hedging strategy.

Figure 3 shows that monthly auction prices (auctioned in 6-monhly tranches twice per year) are good indicators for spot price differences between the beach at St. Fergus and the National Balancing Point. Deviations can be explained by information revealed after the six months auction (See [12]). Industry sources suggest that daily spot prices are in line with the other two indicators shown in the figure. In our model for long-term auctions we will summarize daily and monthly capacity auctions as short term auctions. We furthermore abstract from seasonal variations of available transmission capacity and demand, the effects of which can be observed in Figure 3. In long-term auctions the seasonal capacity variations are addressed by capacity rights with a seasonal profile.

[4] A shipper is anyone who has a license to put gas into the network; also, any producer who lands gas at one of the nodes on the network.

[5] Madhumita Chakraborty: Expert group signals foray into oil futures, Financial Express, Tuesday, March 21, 2000, see also [16].

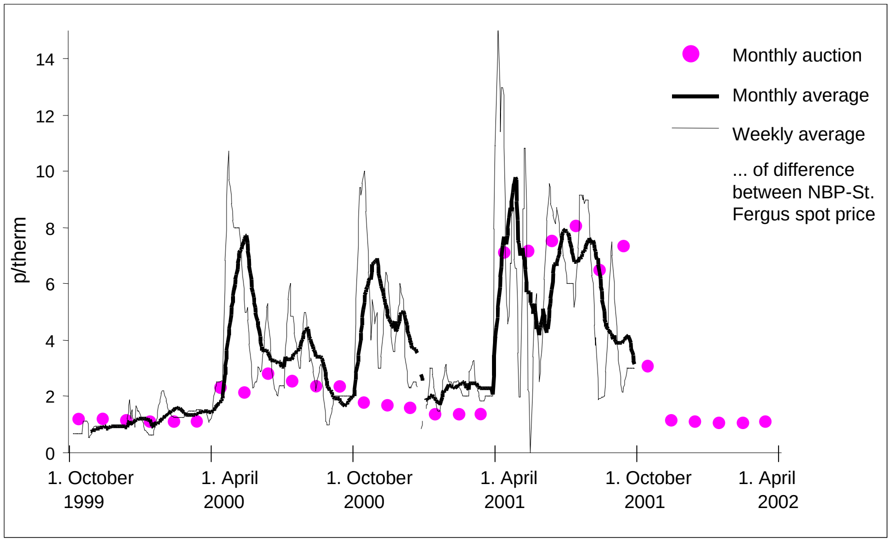

Figure 3: Monthly averaged price difference between day-ahead spot market for gas at St. Fergus and National Balancing Point and weighted average prices paid in auction for monthly entry rights.

2.4 Capacity expansion

We assume the transmission operator and the regulator jointly determine the bidding procedure and that the regulator can use incentive schemes to motivate the regulated monopolist to implement any procedure. For the initial model the procedure is characterized by the parameter s, the fraction of total capacity allocated in the forward auction, and the reserve price, r, which equals a fraction of the marginal cost of expansion, $0.8c$. We assume that additional capacity is available at constant costs c per unit of capacity expansion; in reality scale effects usually imply that investment is only performed if a significant amount of extra capacity is required. The cost, c, can be thought of as the long run marginal cost (LRMC) of expanding the network to meet expected demand growth.[6]

Ofgem's current proposal for the long-term auction envisages bundled strips of 5 year capacity or unbundled strips of 1 year series of capacity to be auctioned.[7] A short time horizon has the disadvantage that shippers can bid for high quantities so that excess

[6]Prior to the introduction of capacity auctions shippers paid NTS use of system charges consisting of commodity and capacity fees. The commodity fee was a flat unit rate; the capacity fees varied depending on the entry and offtake nodes on the network and were calculated by Transco on the basis of the LRMC of accommodating a sustained increase in demand between system nodes. (See Transco's *Ten year Statement 1998* for a description of the LRMC calculation: http://www.transco.uk.com)

[7]Ofgem: Transco's National Transmission System System Operator incentives 2002-2007, Final Proposals, December 2001

capacity will exist and subsequent auction prices will be low. A longer time horizon as proposed by some respondents to the consultation process preferably corresponding to the life time of the investment, could prevent such behavior but would create rigidity in the system. If one producer anticipated high output during the initial years and a second producer only assumed higher production in subsequent years then their needs would not be matched in the long-term auction. One could imagine scenarios where both bid for capacity resulting in excessive investment or alternatively where neither bids resulting in under-investment.

2.5 Auction design challenge

Auctions for access to the gas network deviate from a standard single unit auction with affiliated values in five significant ways: first multiple units of access rights are offered for each terminal. Second access rights for several terminals are auctioned concurrently and the value attributed to the rights by a shipper at one terminal depends on the price to be paid at other terminals.[8] Third the number of access rights issued for a terminal depends on the quantity required at other terminals, because most capacity constraints are not at the terminal but in the network, and therefore Transco has some flexibility as to which terminal to allocate the capacity. Fourth, long-term auction results determine investment in capacity expansion. Sufficient capacity gives a shipper the flexibility to expand future output beyond the level he contracted in the long-term market. Fifth, the auctioneer is not primarily interested in maximizes auction revenue for the regulated monopolist, but instead cares about competition in production and supply and security and efficiency of gas supply.

Subsets of these deviations from a simple auction suffice to ensure that the auction is in general not efficient. Regarding point two Jehiel and Moldavanu [7] show that if signals for bidders are multi-dimensional (e.g., private information about expected production at different possibly multiple terminals) then full efficiency is in general not achieved. Regarding points four and five Jehiel, Moldovanu and Stacchetti [8] show that with externalities standard auctions loose many of their appealing properties and these properties can not be reinstated by subsequent retrading.

Acknowledging that an efficient design is theoretically infeasible for the context we consider the challenge is now to find the least bad solution. In McDaniel and Neuhoff [12] we argue and illustrate with historical experiments that short-term auctions for entry-rights are an

[8] In FCC auctions for radio spectrum companies value spectrum based on whether they obtain spectrum in neighboring regions or whether technology applied by provider in neighboring region is compatible with own technology.

appropriate mechanism to provide access to the network at times of scarcity. We now assess how the additional complications of a long-term auction change the result.

The analysis is simplified by the fact that a significant proportion of access rights are allocated in the short term market and that rights are defined as use it or loose it rights. This make a liquid spot market possible and prevents withholding of capacity to influence market outcomes in the spot market. All companies will therefore value their rights based on the spot market values and any difference between the spot market prices and the price of long-term contracts represent a sunk cost with little impact on the competition.[9]

2.6 Currently discussed UK auction design

Two open ended auction designs have been proposed for the UK by the regulator Ofgem[10]. The first design is a pay-as-bid auction where all bids are accepted which are either supported by existing capacity or for which the lowest bid is still high enough to pay for the corresponding capacity expansion. The second design is an iterative approach whereby Transco announces prices that are increased until the capacity, which shippers bid for at the announced price, coincides with the existing capacity. If more than the existing capacity is required at price c then it is assumed that Transco will expand the network to accommodate demand.

When bidders in an auction have affiliated values (e.g., the value to any one bidder is correlated to the values of other bidders), then bidding is expected to be more conservative relative to the case in which bidders have private values. This is because participants fear the winner's curse; i.e., paying too much for the object. From Milgrom and Weber [13] we know that open auctions are generally preferable to sealed-bid auctions when there are common values, because the outcry process leads to more aggressive bidding. The intuition behind this result is that the observation of when others drop out of the auction (and hence the information this reveals about their values) reduces the possibility that the winner will pay too much for the object. Conversely, the open outcry process may make collusive strategies feasible.

Also contrary to private value auctions, increasing the number of buyers in common value auctions can decrease instead of increase the expected revenue for that seller. That is, increasing the number of bidders can lead to more conservative bidding when values are

[9] The 3G auctions in Europe show that auction fees which appear to be sunk costs nevertheless can influence subsequent decisions. We indirectly incorporate these effects by assuming a fixed cost c_i of participating in the long-term auction, which reduces competitiveness of the long-term market.

[10] Long term signals and incentives for investment in transmission capacity on Transco´s National Transmission System, Ofgem, March 2001.

correlated. The fact that you win an object in common value auctions suggests to you that you likely paid too much since you beat everyone else. The more bidders competing against you, the more likely you are to be cursed if you win.[11] These results suggest a trade off between increasing competition on the own hand, and preventing the winners curse on the other.

We believe that the sealed-bid sequential auction, currently applied for the allocation of monthly access rights, where bidders are given feedback between rounds, mimics the properties of the open outcry auction. The information obtained between rounds allows shippers to learn about the values of other bidders and therefore decreases the chance that they will be subject to the winner's curse. Yet, if there is market power at an entry point, multiple rounds can serve to maintain collusion.

A further purpose of multiple rounds is to give shippers some flexibility for trade-offs between different terminals. Similar trade-offs are provided for in US spectrum auctions where bidders can withdraw bids for spectrum in one region to allow them to react to events in neighboring regions. The value spectrum has for bidders is positively correlated with owning spectrum in neighboring regions [17]. Gas shippers may try to obtain access rights for one out of two terminals, but would not necessarily require access rights for neighboring terminals. The value of entry rights at different terminals is nevertheless positively correlated: if entry rights at some terminals are scarce the gas price at the National Balancing Point (NBP) is expected to increase. Higher expected gas prices at the NBP then increase the value of scarce entry rights.[12] In the short-term auctions multiple rounds, each offering part of the total capacity, allow shippers to first try to obtain access rights at one terminal and bid for a second terminal if the rights turn out to be too expensive at the first terminal. In the short-term auctions total system capacity is known and capacity per terminal roughly pre-determined so allocating a fourth of the capacity per round makes sense. It is unclear how such a scheme could be applied to long-term auctions, where total capacity is endogenous to the auction and participation in the auction requires entrants to commit to infrastructure plans.

Our subsequent analysis does not explicitly replicate the suggested auction mechanism, but uses the Cournot approximation. Fortunately, this approximation is exact in our setting because the expected auction price in a situation with network expansion will always be the marginal cost of network expansion c. Therefore it suffices for bidders to specify the quantity they want to obtain since the price is already given. Our model is simplified in

[11] See Bulow and Klemperer for a broader discussion. Bulow and Klemperer also suggest, however, that increases in supply can mitigate the winner's curse by increasing the number of winners and thereby removing or lessening the curse of being among the winners [4].

[12] The NBP is an imaginary point on the network where spot trades are made.

that it does not capture the discrete nature of capacity expansion. In a situation with discrete capacity expansion the marginal bid can be above c if insufficient bids are available to allow for a further step of capacity expansion.

3 The Model

We will use the British gas market to describe the model underlying our results. Many of the issues involved in an auction for entry rights to the NTS in Britain can to our understanding be captured in a two-node setting. Node one represents the beachhead at St. Fergus and node two the NBP. Entry rights correspond to transmission capacity between St. Fergus and the NBP.

The capacity available for inserting gas or electricity into a network is generally a function of the net-flows at the remaining nodes. However, gas-flow patterns in the UK are predictable therefore the current short-term capacity allocation mechanism rather successfully separated the allocation of entry rights from the allocation of exit rights. We follow this concept in the subsequent analysis which allows us to focus the model on entry rights and the role of producers.[13]

We focus on a scenario where constraints exist and therefore capacity expansion is required such that the results of the long-term auction determine the transmission capacity made available in seven years time. We model the allocation and investment process in four steps. At step zero the regulator or transmission operator decides on the fraction of capacity to allocate in the long-term auction. In the first step access rights are auctioned in the long-auction. In the second step the transmission operator decides how much to invest in capacity expansion and in the third step the remaining capacity is allocated in the short term auctions.

As is common in models with a number of stages we use backward induction to find the solution. We begin by finding a solution for step 3, use this solution to determine optimal actions for step 2, and finally, by knowing agents' preferred actions in subsequent rounds, we can determine the solution for step 1.

[13]In the current discussion of transmission rights in the electricity markets a similar separation of entry and exit rights is suggested. We believe that the volatility of electricity flow patterns makes such an approach infeasible.

3.1 Period three

Changes of available transmission capacity in seven years time have a twofold effect. Additional capacity permits additional gas to flow into the network and therefore reduces prices at the NBP. At the same time additional capacity from St. Fergus to the NBP results in higher demand for gas at St. Fergus and will thereby increase beach spot prices. We identify three categories of shippers (companies that are allowed to trade gas), which are identified with different strategies in long-term auctions. The first category are local gas producers, l, who land all their gas for the UK at St. Fergus. Second are national gas producers, n, landing at St. Fergus and other UK terminals. As we assume that other terminals are unconstrained in our model all non-St. Fergus gas is delivered to the NBP. The third category consists of trading companies, t, owning shares of transmission capacity.

We assume a competitive short term market for gas. This assumption is supported by the observation that scarcity prices of entry capacity rights at St. Fergus are continuously high. In a non-competitive market producers landing at St. Fergus would reduce their output in order to capture the scarcity rent. High scarcity prices would then only be observed at times when Transco has to buy back entry capacity rights, but not in the monthly auctions.

Total expected production Q_u at St. Fergus (upstream) equals the total production of n_l symmetric local producers (q_l) and n_n symmetric national producers (q_n). Higher beach prices (p_u) motivate producers to increase their production by the factor $\frac{\alpha}{Q}$. Aggregate production is a function of aggregate intercept $Q = n_l q_l + n_n q_n$ and aggregate slope θ, with $\theta = (n_l + n_n)\,\alpha$

$$Q_u = n_l\,(q_l + \alpha p_u) + n_n\,(q_n + \alpha p_u) = Q + \theta p_u. \tag{1}$$

Each national producer is furthermore assumed to land q_o units of gas at the NBP. For simplicity we assume that this quantity does not change with the price level at the NBP. It follows from (1) and our assumption that transmission capacity stays scarce ($K = Q_s$), that the gas price at the beach equals

$$p_u = \frac{K - Q}{\theta}. \tag{2}$$

The downstream price at the NBP p_d results from market clearing of net demand $D - \frac{\theta}{\gamma} p_d$ (total demand at NBP minus landing at non-St. Fergus terminals) with gas delivered from St. Fergus:

$$p_d = \frac{D - K}{\frac{\theta}{\gamma}}. \tag{3}$$

where $\frac{\alpha}{\gamma}$ is the price elasticity of demand in the downstream market.

3.2 Period two

Transmission capacity is expanded such that the total auctioned capacity Y equals the announced fraction of total capacity, sK. The total auctioned capacity is the sum of bids at or above long term marginal cost of expansion c of all shippers $Y = \sum_{i\in\{l,n,t\}} n_i y_i$.[14]

$$K = \frac{Y}{s} = \frac{\sum_{i\in\{l,n,t\}} n_i y_i}{s}. \tag{4}$$

For example, if the sum of bids is 80 and 80 percent of capacity was auctioned long-term then total capacity must be expanded to $\frac{80}{0.8} = 100$ so that (1-s) is available for the short-term auction.

In the discussion we address the question whether the pipeline operator Transco or the regulator can adapt s to adjust for distortions due to market power.

3.3 Period one

In the auction all shippers choose the quantity of long term rights y_i in order to maximize expected profit.[15] The profit function for a national producer equals the number of rights obtained y_n in the long term auction times their value in the spot market. This value equals the price difference in the spot markets $p_d - p_u$ minus the price c to be paid for the rights. The national producer furthermore sells q_n in the upstream market and q_0 in the downstream market.

$$\pi_n = y_n\left(p_d - p_u - c\right) + \left(q_n + \alpha p_u\right) p_u + q_0 p_d. \tag{5}$$

[14] The currently proposed auction design sets a reserve price of 0.8 times long term marginal cost c. This creates an additional incentive to understate capacity requirements. If in 'reality' a small expansion would be required and therefore the market clearing price in the auction would be c, then market participants with market power will reduce their bidding volume to push the long-term auction price to $0.8c$ and retain profits of $0.2c$ when the real scarcity value realises in period three. However, the current analysis is restricted to a situation where capacity expansion occurs.

[15] When modelling markets with a homogeneous good like the access rights, the basic approaches are either Bertran or Cournot models. In a Bertran model firms are believed to set a price for the good they are selling and subsequently customers buy the cheapest good. Experience in the last years showed that customers are reluctant to switch gas suppliers even in the presence of price differences. This observation does not support the application of a Bertran model. Alternatively a Cournot approach assumes that price evolves until supply matches demand. If a scarcity of transmission capacity exists then shippers will jointly increase prices until demand for transmission has reduced to the available capacity. The choice variable of companies is therefore the capacity yi to provide for shipping.

The FOC with respect to y gives the optimal quantity to be obtained in the auction. Note that Y is the sum of all y_i. We keep Y at the right hand side to simplify the subsequent calculation.

$$y_n = \frac{\left(s - 2\frac{\alpha}{\theta}\right) Q + \gamma s D - s\theta c - \gamma q_0 + q_n}{1+\gamma} + \left(\frac{2\alpha}{s\theta\left(1+\gamma\right)} - 1\right) Y. \tag{6}$$

A local producer does not sell gas at the NBP, therefore we set $q_0 = 0$ and obtain from (6)

$$y_l = \frac{\left(s - 2\frac{\alpha}{\theta}\right) Q + \gamma s D - s\theta c + q_l}{1+\gamma} + \left(\frac{2\alpha}{s\theta\left(1+\gamma\right)} - 1\right) Y \tag{7}$$

Finally we assess trading companies that do not produce any gas. Setting $q_n = q_0 = \alpha = 0$ in (6) gives the quantity traders bid for in the auction:

$$y_t = \frac{sQ + \gamma s D - s\theta c}{1+\gamma} - Y. \tag{8}$$

3.4 Total capacity provided

We can now calculate total capacity requested in the auction. We use the definition of total auctioned capacity $Y = \sum_{i\in\{n,l,t\}} n_i y_i$ and substitute y_i's from equations (6), (7) and (8). Then we use $Q = n_n q_n + n_l q_l$ according to (1) and set $n_n + n_l + n_t = N$ to obtain

$$Y_{auction} = \frac{1}{1+N-\frac{2}{s(1+\gamma)}} \frac{N\left(sQ + \gamma s D - s\theta c\right) - \gamma n_n q_0 - Q}{1+\gamma}. \tag{9}$$

To allow for comparison we need to know the quantity of transmission capacity provided for by a social welfare planner. He provides for sufficient capacity such that the marginal value of additional transmission capacity $p_d - p_u$ equals unit expansion costs c. This gives

$$Y_{opt} = \frac{sQ + s\gamma D - sc\theta}{1+\gamma}. \tag{10}$$

Comparing $Y_{auction}$ and Y_{opt} we obtain

$$Y_{auction} - Y_{opt} = \frac{Y_{opt}\left(\frac{2}{s} - (1+\gamma)\right) - \gamma n_n q_0 - Q}{(1+N)(1+\gamma) - \frac{2}{s}}. \tag{11}$$

It follows that insufficient capacity is provided for ($Y_{auction} - Y_{opt} < 0$) if national gas producers' output at the national balancing point (or other unconstraint terminals) relative to total output at the constraint terminal (St. Fergus) is bigger than the following value:

$$\frac{n_n q_o}{Q} > \frac{1}{\gamma}\left[\frac{Y_{opt}}{Q}\left(\frac{2}{s} - (1+\gamma)\right) - 1\right] \tag{12}$$

If $\frac{Y_{opt}}{Q} \leq \frac{1}{\frac{2}{s}-(1+\gamma)}$ then we obtain insufficient investment ($Y_{auction} < Y_{opt}$) even for $q_0 = 0$, which implies that we do not even need national producers for underinvestment to occur. Local producers under-contract in the long term auction in order to reduce available capacity towards NBP and increase NBP prices and therefore the value of their remaining long-term access rights.

The number n_t of traders does not change the qualitative result. However, in equation (11) more traders reduces the difference between $Y_{auction} - Y_{opt}$ and thereby increase the match between auction result and social welfare maximizers suggestion.

3.5 Entry cost for traders

An increase in the number of traders reduces the profit to be made by each trader in two ways. First, it reduces the difference between auctioned capacity and optimal capacity, thereby reducing the profits to be made on each unit of capacity. Secondly it reduces the market share of each trader. For a given number of traders we can calculate the profit each trader obtains: from (5) set $q_0 = q_n = 0$; substitute y_t from (8); substitute p_d and p_u from (3) and (2); substitute K from (4), and set $Y = Y_{auction}$ from (9):

$$\pi_t(n_t) = \frac{s}{\theta\,(1+\gamma)} \left(\frac{\left(1 - \frac{2}{s(1+\gamma)}\right)(sQ + \gamma s D - s\theta c) + \gamma n_n \frac{q_0}{s} + \frac{Q}{s}}{1 + N - \frac{2}{s(1+\gamma)}} \right)^2 \tag{13}$$

The equilibrium number of traders n_t is achieved if all traders make positive profit while any additional trader would not be able to cover fixed entry costs c_i:

$$\pi_t(n_t + 1) < c_i \leq \pi_t(n_t). \tag{14}$$

From equation (**??**) it follows for n_t that $\pi_t(n_t) \sim \frac{1}{1+n_n+n_l+n_t}$ and using (14) gives for the equilibrium number of traders $1 + n_n + n_l + n_t \sim \sqrt{\frac{1}{c_i}}$. The total number of market participants increases only with the root of the reduction in costs. Looking at equation (11) this shows that for a reduction of factor two of the mismatch between auctioned capacity and optimal capacity to be auctioned, c_i has to be reduced by the factor of four. As c_i does never approach 0, unless traders are subsidized, traders will not provide for perfect arbitrage.

4 Discussion

In the previous section we developed a model to illustrate the effect of strategic behavior of bidders if the auction results are used to decide on transmission capacity expansion. The only parameter to be chosen by the regulator or transmission operator was the fraction s of capacity rights to be allocated in the long-term auction. In the next three sections we will assume that the transmission operator uses all publicly available information to chose the optimal s in step zero in order to achieve the best match between transmission capacity provided and transmission capacity required.

We show that a unique efficient s does not exist because of the competing objectives of the auction. A different s to be chosen to satisfy each of three relevant criteria. In section 3.1 we show that with full information s_x will provide for the correct amount of investment. However, as we show in section 3.2, s^* which in general differs from s_x has to be chosen if additional private information is to be revealed truthfully. Section 3.3 shows that a third value, s_0, should be chosen if the goal is to minimize network interactions due to private information of national producers about their production in other parts of the country.

In section 4.4 we discuss the merits of an approach to change s during the procedure. This would allow the auctioneer to achieve two out of the three previous goals, but changing s will destroy the reputation of the auctioneer and therefore interfere with future auctions. Finally, in section 4.5 we analyze whether deviations of Cournot equilibrium are feasible.

4.1 Optimal s_x to avoid biased capacity provision

Equation (11) suggests that we can choose s in order to match $Y_{auction}$ and Y_{opt}. This would involve setting

$$s_x = \frac{1}{1+\gamma}\left(2 - \frac{Q + \gamma n_n q_0}{K_{opt}}\right). \tag{15}$$

For an upper limit to s_x we assume that national and local producers have an equal share in output at St. Fergus. We furthermore assume that output of national producers at the NBP equals total production at St. Fergus $n_n q_0 = Q$. Price elasticity at St. Fergus is $\gamma = 1/3$ of NBP and in the long run equilibrium $K_{opt} \sim Q$. We obtain $s_x \sim \frac{1}{2}$. Only if exactly the fraction s_x of total capacity is offered in the long-term auction then the distortions of individual bidders cancel each other and in the presence of full information the appropriate amount of capacity is provided by the long-term auction.

4.2 Optimal s^* to achieve revelation of private information

In the previous section we analyzed the effect of s on the future investment, assuming that all information was publicly shared. Now we incorporate the effect that producers have additionally with their private information. The purpose of the auction is to reveal such information in order to provide for the optimal amount of capacity. However, producers only focus on their individual profit. The calculation shows that the result is that they usually do not perfectly reveal their private information. Rewriting (6) to ensure that y_n only appears on the left hand side we obtain:

$$y_n = \frac{\left(s - 2\frac{\alpha}{\theta}\right) Q + \gamma s D - s\theta c - \gamma q_0 + q_n}{2\left(1+\gamma\right) - \frac{2\alpha}{s\theta}} + \frac{\frac{2\alpha}{s\theta(1+\gamma)} - 1}{2 - \frac{2\alpha}{s\theta(1+\gamma)}} \left(Y - y_n\right) \tag{16}$$

Please note, that Y is the sum over all y_i and therefore $Y - y_n$ does not contain the y_n we are calculating.

We want to know by how much a national shipper changes his bid in the long term auction, if his private signal changes while all other players retain their signal. Differentiating (16) with respect to q_n we obtain

$$\frac{\partial y_n}{\partial q_n} = \frac{s - 2\frac{\alpha}{\theta} + 1}{2\left(1+\gamma\right) - \frac{2\alpha}{s\theta}} \tag{17}$$

The auctioneer anticipates how shippers change their bids based on their private information q_n and intends to choose the optimal s^* such that the provided capacity matches the additional/reduced requirements. Using the investment condition in equation (4) we calculate the expected effect of private information on the final allocation:

$$\frac{\partial K}{\partial q_n} = \frac{1}{s}\frac{\partial y_n}{\partial q_n} = \frac{s - 2\frac{\alpha}{\theta} + 1}{2s\left(1+\gamma\right) - \frac{2\alpha}{\theta}} \tag{18}$$

In the optimal scenario the system operator wants to ensure that shippers bidding according to their private information results in the same capacity expansion as would have been suggested by the optimal planning condition (10). $\frac{\partial K}{\partial q_n} = \frac{1}{1+\gamma}$ and chose

$$s^* = 1 - \frac{2\alpha\gamma}{\theta\left(1+\gamma\right)} = 1 - \frac{2\gamma}{\left(n_n + n_l\right)\left(1+\gamma\right)}$$

If we assume that two national and two local producers dominate production at St. Fergus then we obtain the optimal $s^* = 0.875$. See figure (4)

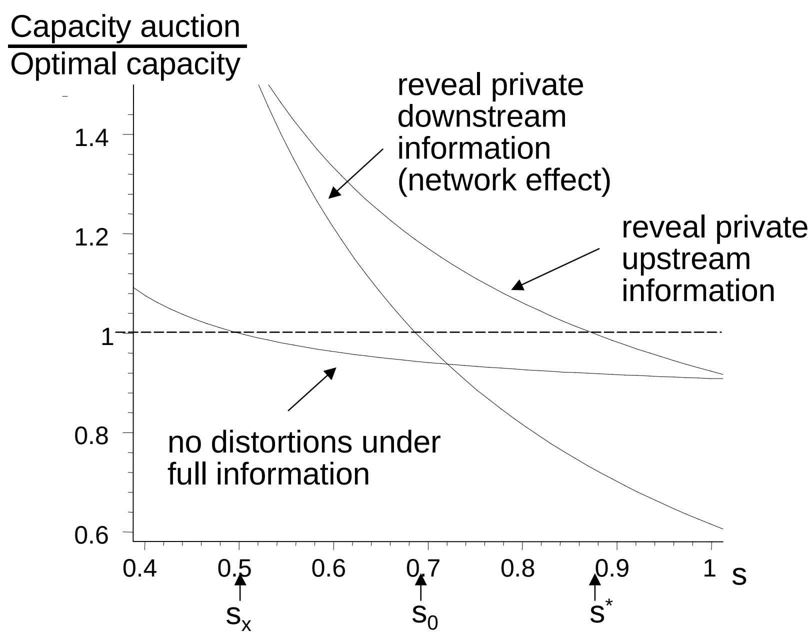

Figure 4: Assuming the auctioneer could perform the above calculations to determine the optimal s, then he would have to compromise between three different values of s.They are optimal dependent on whether expected bias is to be eliminated (s_x), truthful revelation of additional information is to be achieved (s^*) or interference due to the network is to be minimised (s_0).

4.3 Optimal s_0 to minimize distortions through network effects

The auction result is furthermore distorted by changes in expected output of national producers q_0 at terminals other than the terminal we are concerned about. According to (16) we obtain

$$\frac{\partial K}{\partial q_0} = \frac{1}{s}\frac{\partial y_n}{\partial q_0} = \frac{-\gamma}{2s\,(1+\gamma) - \frac{2}{(n_n+n_l)}} \tag{19}$$

Once again we require that the capacity change in the auction equals the capacity change implemented by a informed regulator, and obtain according (10):

$$\frac{\partial K}{\partial q_0} \equiv \frac{\partial K_{opt}}{\partial q_0} = -\frac{\partial K_{opt}}{\partial D} = -\frac{\gamma}{1+\gamma} \tag{20}$$

Combining (19) and (20) we obtain an the equation for the optimal s_0:

$$s_0 = \frac{1}{2} + \frac{1}{(1+\gamma)\,(n_n+n_l)} \tag{21}$$

Using the previous parameter values gives $s_0 = 0.69$. The higher the output of national producers is upstream, the higher can s be. If $s < s_0$ then national producers private information about changes of their future downstream output results in excessive adaption to transmission capacity, and $s > s_0$ implies too little revelation of private information.

4.4 Can s be changed in step 2?

An alternative approach to optimize the auction outcome would be to sell a fraction $s_1 = s^*$ of total access rights in the initial auction to allow for full revelation of private information. In step two the market power distortions could be corrected by applying an s_2 that differs from the s_1 announced during the auction process. Alternatively high $s_1 = s_0$ could be initially chosen to fully capture private information from national shippers about changes in output downstream and systematic bias from market power corrected for at step 2.

However, the subsequent change of s_1 towards s_2 in step two would not be welcomed by the market, and is infeasible in any repeated game, as shown by experience from inflation targeting of central banks. Central Banks like to increase the amount of money circulating in the economy in order to stimulate the economy: More money allows agents to buy more services, which results in more production etc. But if agents anticipate additional money to be circulated in the economy then they will increase prices and wages. In equilibrium the additional money issued by the Central Bank is matched by higher prices such that the amount of services and products bought stays constant. The only result of the economic ambitions of the Central Bank is inflation. Therefore most Central Banks that are headed by conservative bankers are believed to have little interest in stimulating the economy but significant interest in maintaining low inflation. Such Central Bankers will only increase the volume of money issued as a result of events that are unanticipated by all players. If a Central Banker will increase the money volume more than previously announced in order to stimulate the economy he and the bank looses the credibility as a conservative banker. In the future markets will anticipate similar behavior and future inflation will be higher.

This experience corresponds to the auctioneer's decision process. Transco announces the factor s_1 to inform shippers about the link between auction results and capacity expansion. Shippers bid in the auction based on their beliefs about subsequently capacity investments. The auctioneer can deviate once from the announced s_1 but in all subsequent years shippers will anticipate such behavior and include it in the bidding strategy.

4.5 Danger of foreclosure

Can shippers reserve excessive capacity in the long-term market such that competitors cannot obtain sufficient capacity in the spot market? Faced with shortage of transmission capacity in the spot market competitors would lag growth potential or even have to default on existing contracts. If such a scenario were realistic it would imply that all shippers amply contract in the long-term auction to ensure sufficient capacity will be available for their own needs or to foreclose competitors. We believe that such a scenario is unlikely for the following three reasons.

First, withholding transmission capacity is difficult. For a producer such as a generator withholding output because competition authorities have problems attributing such behavior to intentional market manipulation.[16] For the owner of transmission capacity withholding output (i.e., capacity rights) is more difficult since this behavior can be observed and verified by the competition authorities.

Second, we mentioned at the beginning that we assume that the transmission operator Transco will make a significant fraction $(1 - s)$ of transmission capacity available in the short-term time frame of a year or less - the main motivation being the support of potential entrants, but furthermore allowing to prevent foreclosure. This additional capacity makes foreclosure in the long-term market counter-productive since over contracting signals the need for more investment which makes more (not less) capacity available in short term markets.

[16] Experience in the California electricity market indicates that it is hard to differentiate between electricity generators withholding capacity and planned outages for revision or breakdowns (Joskow and Kahn[9]).

A third argument is related to our previous model. We analyzed shippers' strategies with a Cournot model to ensure that small unilateral deviations are not profitable. But would a large deviation by shipper, requesting a large quantity in the forward-market, be profitable? This shipper could then try to foreclose competitors in the spot market.

Such a deviation seems unlikely. We mentioned above the difficulties of foreclosure in an easily controllable market; in addition to this competitors would observe the behavior of the deviating shipper for example by analyzing the aggregate capacity bids in the long-term auction. If competitors were worried about being victim of such a foreclosure in the future they would reveal their information to the auctioneer, the regulator or the competition authority. Based on this information the auctioneer could re-evaluate and re-decide on the investment and allocation strategy.

5 Conclusion

Short-term auctions for access to terminals of the British gas-network have been used since September 1999 and appear to successfully allocate scarce resources and capture scarcity rent. Now long-term auctions are being introduced to guide future capacity expansion decisions.

It is important for competition that some access rights be made available in spot markets. In our model the fraction of total rights issued in the long-term auction turns out to be a crucial design parameter. Even a 'hypothetically' optimal parameter choice can in general only satisfy one of three competing aims: unbiased provision of capacity, full revelation of private information, and minimization of distortions from network effects. Gas industries are characterized by asymmetric agents who produce and sell at different points on the network. In this setting, private information about production can give incentives for over or under investment depending on the proportion of capacity reserved for spot markets.

One alternative to long-term auctions is a regulatory approved decision about capacity expansion by the transmission owner. This decision would be based on the same publicly available information as the decision about the optimal s, but would not be influenced by privately held information and would consequently be less prone to error caused by information about production at other entry terminals. Producers would be willing to reveal private information about expected output growth because additional capacity would increase the value of their output and they would not face the 'artificial' incentive to push up the value of their long-term entry rights by withholding information. However, shippers might overstate capacity requirements to reduce risk of congestion, in order to increase the expected value of their gas.

Our simple model does not allow for a comprehensive analysis of the trade-off between regulatory approved capacity expansion and expansion based on auction results. However, it suggests that investment bias and withholding of private information can be a significant drawback of long-term auctions

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