

## **TRANSCO PRICING CONSULTATION PAPER PC53**

### **NTS Entry Capacity Auction Revenue Re-balancing**

#### **Summary**

The introduction of auctions for NTS entry capacity does not alter the amount of revenue which Transco is permitted to raise under the price control formula set out in its PGT Licence. However, auctions create uncertainty about the level of revenue generated through NTS entry charges. This has been seen clearly in the recently completed entry capacity auctions, with the prices bid by shippers implying a significant increase in the amount paid via NTS entry charges.

This consultation paper considers how any revenue variation as a result of auctions should be dealt with. The paper considers both the general issues and the specific question as to how to deal with any excess revenue resulting from the recently completed NTS entry auctions.

The paper outlines a number of ways in which revenue might be adjusted, and proposes that significant future revenue variations might be reflected through an adjustment to the NTS Commodity Charge. However, views are also invited on whether a different approach would be appropriate for the present circumstances, covering NTS entry charges for the period April to September 2000. In particular, views are sought on whether it would be appropriate for entry charges over this period to be lower than the successful bids registered by shippers in the auctions.

Views are being sought by 19 April such that it may be possible for any amendments to transportation charges to apply from 1 May.

## Introduction

Prior to the introduction of New Gas Trading Arrangements (NGTA) in October 1999, Shippers booked NTS entry capacity for a twelve month period and were invoiced on the basis of administered charges. These charges were calculated in accordance with Transco's Transportation Charging Methodology. This involved setting entry charges designed to generate about one third of Transco's target revenue from NTS charges. Under the NGTA, Transco auctions Monthly System Entry Capacity (MSEC). This necessarily introduced uncertainty into the average price paid for entry capacity and hence for Transco's revenue from charges for NTS entry capacity. This does not, however, affect Transco's allowed revenue under its price control formula and Transco will continue to set transportation charges at a level consistent with the requirements of that formula.

While any revenue variation as a result of auctioning MSEC can be taken into account when Transco's transportation charges are next reset, normally on an annual cycle, it may be preferable for an earlier adjustment to be made in some circumstances. This issue has been brought into sharp focus by the auctions held over the period 16 to 24 March 2000. The prices bid in those auctions imply Transco's revenue for April to October 2000 MSEC being significantly above the level which would have been collected under the previous Transportation Charging Methodology. This additional revenue as a result of bidding patterns is estimated to be about £85m, some 250% of the "target" level. Variations in revenue collection on this scale raise a number of issues for both Transco and the industry as a whole:

1. Cost Reflectivity – Transco's PGT Licence suggests that, in most cases, transportation charges should be set to reflect costs actually incurred. Charges based on the bids seen in the recent MSEC auctions imply a move away from cost reflectivity, with NTS charges accounting for a greater share of revenue. While moving away from cost reflectivity is to some extent an inevitable consequence of introducing auctions, the question arises as to whether the impact should be ring fenced within the NTS charging tier in order to maintain other charges at the levels generated by the present transportation charging methodology. Adjustments to the general level of transportation charges as the means of dealing with variations in revenue from MSEC auctions might be regarded as introducing a cross-subsidy. This would be because the bulk of any adjustment would be accounted for in non-NTS charges, since these account for the majority of Transco's revenue. This may be seen as particularly disadvantaging NTS connected customers.
2. Price stability – major swings in revenue make it more difficult for Transco to maintain year on year price stability while complying with the price control formula requirements for two reasons. First, bids in the recent auctions were relatively high but it is by no means certain that this will prove to be the general outcome from MSEC auctions. It may, for example, reflect the particular balance of supply and demand expected over the next six months, rather than longer term factors. If transportation charges from October 2000 were set lower than otherwise to reflect revenue in the recent auctions, an assumption would be needed about revenue from future auctions. The appropriateness of the adjustment would then be dependent on the accuracy of that assumption, and it is almost certain that actual revenue will either over- or under-recover against the forecast. Second, the price control formula applies to the year ending 31 March. If charges are adjusted in

October rather than earlier, the scale of adjustment to comply with the formula is relatively large since it only applies for six months. This can in turn mean entering the following formula year with relatively low transportation charges, and Transco may wish to increase charges in order to collect the revenue allowed by the price control formula. Transco believes that such price volatility should be avoided wherever possible.

1. Cashflow effects – while the price control formula ensures that the total level of transportation charges is not affected by bidding patterns in auctions, the timing of payments is potentially changed. This has financial implications for both Shippers and Transco, and a stable and predictable pattern of payments can be beneficial to the industry as a whole.

This suggests that there may be merit in modifying the Transportation Charging Methodology such that, following an auction, the level of transportation charges payable in the period to which the auction applies can in certain circumstances be adjusted in the light of the auction outcome. Any change of this nature should, however, ensure continued compliance with the PGT Licence requirements for the Transportation Charging Methodology, and other statutory requirements, including the Network Code. In particular this means that, apart from charges set by auction, charges should be set against the background of a requirement for charges to be cost reflective. In addition Transco believes it is important to ensure that any changes to the Transportation Charging Methodology do not undermine the benefits of allocating MSEC by means of a market mechanism.

Within this framework, a number of alternatives for revenue adjustment exist, as considered below.

### **A. Adjusting all Transportation Charges**

It would be possible to scale the major transportation charges in order to reflect any variation in revenue as a result of MSEC auctions. The carry forward of over- or under-recoveries under the present price control formula is already reflected in Transco's transportation charging methodology and, in the absence of change, provides for charges to be set with a view to achieving target revenues which reflect any over- or under-recovery.

This approach may be regarded as acceptable provided the revenue determined by auctions is broadly in line with that which would otherwise have been received. The presence of reserve prices in the MSEC auctions limits the scope for revenue variation in one direction. If all capacity had been sold at reserve price, revenue would have been about 75% of the target level. This can be seen as establishing a precedent for future auctions such that any variation in revenue within a range of, say, plus or minus 25% could be rolled forward in the normal way. However, an alternative mechanism may be desirable if more extreme outcomes are seen, such as in the latest round of MSEC auctions.

If it were accepted that any revenue variation as a result of MSEC auctions should be offset by reducing transportation charges in general, the timing of such reductions would need to be considered. To offset revenue fluctuations, it may be possible in principle to adjust charges on a month by month basis to reflect variations in auction outcomes. This would not encourage price stability and Transco would not support it. An alternative might be to spread any

adjustment over the lifetime of an auction, but this could be problematic if longer term auctions are introduced. Transco would suggest that it may be appropriate for any adjustments to be calculated on the basis that they apply for a full year, based on either the gas year – October to October – or the price control formula year – April to April.

Views on the appropriate time scales to consider would be welcome, but an example of possible practice would be to assume that MSEC is auctioned for a gas year in, say, July. This would enable Transco to calculate any necessary adjustment to charges which may apply from 1 October, and announce this by 1 August, thereby providing two months notice of changes in prices as presently required by the Network Code. Were longer term MSEC to be auctioned, any revenue implications for later years could be taken into account as part of Transco's general assessment of the appropriate level of transportation charges rather than requiring a specific adjustment mechanism.

In the specific circumstances surrounding the last round of MSEC auctions, it would be possible to reduce transportation charges for the remainder of the present formula year. Subject to consultation and acceptance of a reduced notice period, it would be possible for such reduced charges to be implemented from 1 May, with the adjustment based on assuming the reduction applied until 31 March 2001. However, this makes no allowance for any potential revenue variation following the auctions anticipated to cover the period from October 2000, and it may be preferable to adjust charges with a view to substantially offsetting the revenue raised by 1 October, i.e. the period covered by the MSEC auction. This would, however, almost certainly lead to increased transportation charges with effect from October, potentially creating price instability and hence is not recommended by Transco.

## **B. Adjusting NTS Commodity Charge.**

As mentioned earlier, it may be considered preferable to ring fence any adjustment to NTS charges rather than adjusting all transportation charges. The case for this would apply whether an adjustment were made in the light of any auction outcome or if a specific adjustment were made only if revenue variations exceeded some limit, such as plus or minus 25% as set out above. The timing issues above would also be relevant.

One possibility would be for any necessary adjustment to apply to the NTS commodity charge. Under this scenario the NTS Commodity charge would either be increased or decreased as necessary to seek to ensure that the NTS target revenue was achieved. The charge would therefore act as a balancing item compensating for any under- or over-recovery resulting from the auctions. In the interests of cost reflectivity, however, it may be preferable that the rate should remain positive, and should not fall below the short run marginal cost of operating the NTS.

To some extent, the introduction of SND based MSEC auctions under the NGTA could be regarded as having effectively introduced a pseudo commodity charge at entry. This implies that adjustments to the administered commodity charge to balance any under- or over-recovery might be expected to produce relatively limited distributional effects between customer groups. However, this understates the potential distributional impact between shippers, with the effect depending on the nature of shipping. In particular the effect could be different depending on whether shipping to or from the National Balancing Point. Focussing

adjustments on NTS commodity charges could also affect customers supplied on the Optional NTS Tariff differentially if they did not automatically see the same reduction as other loads.

Views on the relative distributional impacts of adjustments focussed on the NTS Commodity charge as opposed to the generality of charges would be welcome.

### **C. Adjusting NTS Exit Charge**

If it were considered desirable to ring fence any revenue adjustments to NTS charges, a second alternative would be to adjust NTS Exit charges. NTS Exit charges would either be increased or decreased as necessary to ensure that the NTS target revenue was achieved. This could be achieved either through an equal absolute or percentage adjustment.

Compared to adjusting the NTS Commodity charge, this approach might tend to have a greater distributional impact because exit charges vary between exit zones. This may be regarded as unnecessarily distorting the economic signals provided by exit charges derived from estimates of long run marginal costs. In addition, the impact on interruptible loads would be markedly different since these loads do not attract exit capacity charges at present.

Transco does not believe it would be appropriate to focus any adjustments on NTS exit charges, but would welcome views on this.

### **D. Adjusting Entry Charges**

A fourth option focussed on adjusting NTS charges alone would involve issuing invoices which were not based on accepted bids in MSEC auctions. Under this scenario accepted bids from MSEC auctions could be adjusted upward or downward as necessary to ensure that a target revenue was achieved. A number of options for achieving such an adjustment can be envisaged. For example, invoices could be based on bids which were scaled by the same percentage, or the same absolute amount, based on the same parameters at all terminals, or on terminal specific parameters. Alternatively only the highest bids could be adjusted, effectively putting a cap on maximum acceptable prices.

Focussing any adjustment as a result of MSEC auction related revenue variation on entry charges may be considered desirable since it would be targeted on the area where the revenue difference arose. It offers, therefore, the potential to neutralise any undesired or unanticipated effects from the auctions. However, this strength may also be considered the key weakness of the approach since it may not only neutralise undesired impacts, but may also neutralise the beneficial impacts which auctions have been introduced to deliver. Any break in the link between the bid price and the price paid could risk creating auctions which are no longer an efficient means of allocating a finite resource and which fail to generate efficient market signals about the true value of capacity at specific locations. In extremis, the approach could amount to constraining prices paid to a pre-determined level and a return to administered charges.

Transco does not, therefore, believe that it would be appropriate to create any expectation that it would in future amend the transportation charging methodology such that the amount paid for entry capacity would differ from the amount bid in MSEC auctions. This would clearly undermine the rationale for auctions. However, while this may be the case for future auctions,

views on the acceptability of this approach as a one off exercise in light of the outcome of the recent MSEC auctions would be welcome. In particular views on the likelihood of this approach affecting bidding strategy in future auctions are invited.

If respondents favour an early adjustment based on this approach, views would also be welcome on the precise mechanism for translating accepted bids into invoiced entry capacity charges. Transco's preference would be for a relatively simple adjustment mechanism, allowing early implementation at reasonable cost. It would, for example, be feasible to reduce all accepted bids by the same percentage across all terminals - uniform scaling. More complex alternatives, such as terminal specific adjustments or rebates based on UDQIs, would take longer to develop and hence any reductions in charges would necessarily be delayed. In the case of UDQIs, for example, no existing transportation charges are based on this item and hence a new charge category would need to be developed, with consequences for invoice production. This could also imply creating a negative transportation charge, which may cause conflicts with elements of the Network Code and the price control description in Condition 9C of Transco's PGT Licence. It may, for example, be necessary to amend the PGT Licence in order for any such rebate to be accounted for as negative income within the price control formula, and this could delay any implementation date.

### **Other Issues**

In addition to concerns about the level of revenue implied by bidding behaviour in the recent MSEC auctions, widespread concern has been expressed about the level of reserve prices which will apply in forthcoming auctions of daily capacity. However, while it has been suggested that these prices should be reduced in the interests of delivering the lowest possible final prices, others have suggested that the structure of the daily reserve prices was an integral part of the auction design and, as such, had a material influence on bidding strategy.

Transco believes that the link between the monthly auction outcome and daily auction reserve prices can be expected to have been a factor taken into account by bidders in the MSEC auctions. Changing the daily auction reserve price now could, therefore, affect participants view of the relative success of their bidding strategy and be seen as providing an unwarranted redistribution between bidders. Transco would not, therefore, support changing this parameter alone. If, however, an adjustment were made such that the price paid for MSEC was less than the amount bid, Transco believes that it would be appropriate to also amend daily reserve prices such that the multiplier established by the transportation charging methodology, one, was applied to the amount paid rather than the amount bid. Transco would welcome views on this approach.

High revenue from the recent MSEC auctions does not increase the maximum level of transportation charges which Transco's price control formula allows it to collect. While this will ensure there is no change in the aggregate amount paid, the MSEC auctions will lead to a redistribution of charges. Transco would welcome views as to whether any particular group will be adversely affected, and whether special arrangements should be made to avoid the most extreme effects and inefficient economic signals. It has, for example, been suggested that some large loads close to entry terminals are experiencing particularly large increases in charges as a result of the auctions. Unless adjustments are focused on entry charges, these loads are unlikely to see a significant benefit from any redistribution of the revenue raised as a result of

the recent MSEC auctions. This may give an incentive for such loads to build dedicated pipelines which bypass the NTS. This can lead to unnecessary duplication of infrastructure and would appear to be an inefficient outcome. Any views on the extent of this problem, and whether special arrangements should be introduced to ameliorate these problems would be welcome.

## Conclusion

### Future Auctions

Transco proposes that a mechanism should be established in future for adjusting revenue when the outcome of MSEC auctions would otherwise create a significant cash flow variation. In order to ensure this is ring fenced to the NTS charging tier and does not undermine the auction outcome, Transco believes that the most appropriate way to achieve this may be by adjusting the NTS Commodity charge as appropriate whenever the outcome of an auction implies revenues 25% greater or lesser than a predetermined “target” revenue. The adjustment should be based on the assumption of returning revenue to within the 25% tolerance band within the period over which the auction applies. If this proposal is accepted, Transco will consult further with a view to implementing a change to the transportation charging methodology in time for the next round of MSEC auctions.

### March 2000 Auctions

While Transco proposes the above adjustment mechanism as a medium term solution, it is not clear that this is appropriate as an ex-post mechanism for adjusting the outcome of the recent MSEC auctions. Transco accepts that there is a case for making changes to transportation charges earlier than the next expected opportunity for change, 1 October 2000. However, as this paper has demonstrated, there are a number of options for achieving this, and each option has disadvantages as well as advantages. Views on the merits of these options as one-off adjustments would be welcome.

The first option would be to reduce all transportation charges from 1 May, increasing the previously announced reduction due to take effect from that date. If this were implemented with a view to offsetting all of the revenue variation by 1 October, the previously announced reduction would need to be increased by 11%, making a 14% reduction in total. Transco does not recommend this option because the change is not ring fenced to the NTS, and because of the implications for price stability.

The second option would be to reduce the NTS commodity rate. Transco would suggest that this should not be reduced below the short run marginal cost, which would imply a rate of 0.0022p/kWh, sufficient to cover typical summer operating costs (NTS compression and unaccounted for gas). This would reduce Transco’s revenue across the summer months by approaching £50m. Transco believes this has merit since it provides a reduction focussed on the NTS and does not disturb the auction outcome. However, there would be distributional effects and Transco would welcome views on the appropriateness of applying this reduced NTS Commodity Charge with effect from 1 May.

**A third option would be to adjust NTS exit charges. While views on this would be welcome, Transco does not believe this would be well targeted and that it could introduce undesirable market distortions. The option is not recommended.**

**Finally it would be possible to adjust the outcome of the recent MSEC auctions such that bidders pay less for capacity than their bid. These lower charges would also be reflected in adjusted reserve prices in auctions for daily capacity. Transco does not generally support options which adjust the outcome of auctions, but believe there could be merit in making a one-off adjustment in the particular circumstances seen at the moment. Were respondents to support such an adjustment, Transco would suggest that the adjustment should be as simple as possible in order to facilitate speedy implementation. Were the approach to be adopted, Transco's proposal would be to reduce all prices bid in MSEC auctions by 60%. This would substantially remove the potential revenue variation by 1 October 2000. It would, however, also mean some capacity being sold at less than the reserve prices in place for the MSEC auctions, and would give the largest reductions to the highest bidders. Views on the desirability of this approach would be welcome.**

**Transco believes that changes to the Transportation Charging Methodology as outlined above would be consistent with the relevant objectives set out in the PGT Licence since they are designed to reflect business developments.**