TRANSCO PRICING CONSULTATION PAPER PC 60

Re-balancing Revenue Raised by MSEC and Other NTS Auctions

Summary

The introduction of auctions as the means by which various NTS transportation services are allocated, 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 transportation charges.

This issue was brought into sharp focus by the March 2000 Monthly System Entry Capacity (MSEC) auctions, the results of which implied a significant level of revenue over-recovery. In order to prevent this situation from developing countervailing action was taken in the form of reductions in NTS transportation charges. During the associated consultation process (PC 53), there was broad agreement between Transco, Ofgem and the shipper community that the Transportation Charging Methodology should be amended to include a mechanism by which future revenue variations as a result of auctions might be mediated.

This 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.

1. Introduction

Prior to the introduction of New Gas Trading Arrangements (NGTA) in October 1999, all transportation revenue was raised on the basis of administered charges. These charges were calculated in accordance with Transco's Transportation Charging Methodology. This involved setting transportation charges designed to generate Transco's target revenue. Under the NGTA, Transco has started to allocate a number of transportation services by means of auction. This necessarily introduces uncertainty into the average price paid for these transportation services and hence for Transco's revenue. 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.

2. Discussion

Revenue variation, for whatever reason, is taken into account during the normal processes by which Transco resets transportation charges. The nature and scale of any variation arising from auctions means that consideration of a specific adjustment mechanism is justified. This issue has been brought into sharp focus by the Monthly System Entry Capacity (MSEC) auctions held during March 2000. The prices bid in those auctions implied revenue 250% of that which would have been collected under the previous Transportation Charging Methodology. 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. As illustrated by the March 2000 MSEC auctions, having some charges derived from an auction process may imply a move away from this. While moving away from cost reflectivity, for the direct charges involved is to some extent an inevitable consequence of introducing auctions, the question arises as to whether the impact should be ring-fenced within a particular tier of transportation charges. Ring fencing would maintain the level of charges within individual tiers as generated by the present Transportation Charging Methodology. Adjustments to the general level of transportation charges in order to compensate for revenue variation within a particular tier may be regarded as introducing a cross-subsidy. This is a particular issue with regard to the NTS tier; the bulk of any general adjustment would be accounted for in non-NTS charges, so raising distribution issues with regard to NTS connected customers.

2. Price stability – major swings in revenue make it more difficult for Transco to (a) comply with the price control formula and (b) maintain year on year price stability simultaneously. The present mechanism by which these two objectives are achieved may not be suitable for coping with revenue variation associated with auctions. Bidding patterns in any single auction cannot be taken as a reliable guide to patterns in future auctions due to the major influence specific market conditions can have. Periodic adjustments to the split between auction derived and administered charge derived target revenue are therefore unlikely to prove a successful method of achieving revenue / price stability. The present adjustment mechanism is such that adjustments for revenue deviation in one period can only be made in future periods. Given recent experience of auctions at 6-month intervals, auctioned transportation services will have a seasonal pattern of usage

with separate auctions for the winter and summer periods. There could therefore be a mismatch in the pattern of usage between the period in which a deviation from target revenue occurred and the period in which countervailing action was taken. This would further increase price instability. Auctions every 12 months may in part mitigate against the seasonal effect.

3. Cash-flow effects – while the price control formula ensures that total transportation income collected over the formula period 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.

4. Permitted variation – so as to reduce the risk of having to adjust charges after each and every auction the adjustment need only apply when revenue variations exceed a certain limit. This limit could either be expressed as a percentage of target revenue from all auctioned transportation services or as an absolute value. In either case the limit should be set so that auction outcomes are as unconstrained as is reasonably possible so as to encourage appropriate bidding behaviour. One consideration might be the effect of these limits on under / over recovery in total, from transportation charges within any period, if auctions were to increase in importance this may have implications for condition 9c of Transco's PGT Licence.

3. Outline Proposal

This suggests that there may be merit in modifying the Transportation Charging Methodology such that, following an auction:

1. The level of transportation charges payable in the period to which auctions apply can in certain circumstances be adjusted, with a reduced period of notice, in the light of the auction outcome.
2. That adjustments made under such circumstances should only apply to charges within the same tier as the auction to which they relate.

Any change should, however, ensure continued compliance with PGT licence and Network Code requirements. In addition Transco believes it is important to ensure that any changes to the Transportation Charging Methodology do not undermine the benefits of allocating transportation services by means of a market mechanism.

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

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 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 any 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. This approach may not be acceptable where large revenue variations occur, having major negative implications for all four issues outlined above:

1. Cost reflectivity;
2. Price stability; and
3. Cash-flow
4. Permitted variation

The presence of reserve prices at auction limits the scope for revenue variation in one direction. This can be seen as establishing a precedent for future auctions such that any variation in revenue within a certain range could be rolled forward in the normal way, with an alternative mechanism if more extreme outcomes are seen.

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 the adjustment was made in the light of any auction outcome or if a specific adjustment were made only if revenue variations exceeded some limit. The timing issues outlined above would also be relevant.

One possibility would be for any necessary adjustment to be made through the NTS Commodity charge. Under this scenario the 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 reduce the risk of having to adjust the Commodity charge after each and every auction the adjustment need only apply when revenue variations exceed a certain limit. This limit could either be expressed as a percentage of target revenue from all auctioned transportation services or as an absolute value. In either case the limit should be set with reference to the impact on target revenue and not just the target revenue from each auctioned service.

To some extent, the introduction of auctions under the NGTA could be regarded as having effectively introduced pseudo commodity charges for affected transportation services. 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 may understate 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. Transco, believes that the net position for those shipping to and from the NBP is dependent on the degree to which prices at all stages of the gas chain adjust in response to the differing influences. So long as the transportation revenue adjustment mechanism is clearly defined in advance, the market should adjust appropriately to minimise these distributional effects. However, adjustments to the commodity charge will be borne by shippers who, conceptually, take gas away from the NBP, leaving spot prices quoted for NBP gas to reflect gas plus entry capacity costs. It is known that NBP prices form the benchmark for a number of gas supply contracts. Shippers who bid for entry capacity and sell on at the NBP will be incentives to manage the risks associated with variable auction prices by as far as possible, sharing that risk with downstream shippers.

The distributional impacts shipping gas to and from the NBP could theoretically be removed if NTS commodity charges were to be levied on entry to the pipeline system rather than at exit as is presently the case. Gas prices quoted at the NBP would reflect the commodity charge item, though the volatility associated with auctions should be removed.

Focussing adjustments on the standard NTS Commodity charge may seem to raise some distributional issues with regard to customers availing themselves of the Optional Commodity charge. The already low rate of the optional commodity charge does not allow much scope for compensating reductions in the charge should higher than required auction income dictate such an adjustment. However, the Optional charge should not be regarded as a discounted standard charge. Rather it reflects the annualised costs of building and operating a pipeline of NTS specification, and these costs remain unaffected by the level of the standard charge. For this reason, in principle Transco does not believe that the Optional charge should be affected by the adjustment mechanism, just as it has remained unchanged despite reductions in the level of NTS charges in recent years.

During period of over recovery those customers paying the Optional tariff would not be compensated for high Entry charges through a reduced Commodity charge. Equally however, during periods of under recovery they would receive the full benefit of lower entry charges without facing an increased Commodity charge. Even if the Optional tariff was adjusted in line with the standard Commodity charge these adjustments would be small relative to the movements in Entry charges. Bypass of the Transco network could therefore be an economic option for customers during certain periods but not others. Transco recognise that this degree of uncertainty is unsatisfactory and would welcome views as to how it might be removed.

C. Adjusting Accepted Bids

Option focussed on adjusting NTS charges alone would involve the adjustment of accepted bids either upward or downward as necessary to ensure that target revenue was achieved. A number of options for achieving such an adjustment can be envisaged. For example, bids could be scaled by the same percentage, or the same absolute amount. Alternatively only the highest bids could be adjusted, effectively putting a cap on the maximum acceptable bid. Where appropriate, scaling could either be based on the same parameter at all geographical locations, or on geographically specific parameters.

Focussing any adjustment as a result of auction related revenue variation on the auctioned transportation service itself might 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 less efficient means of allocating a finite resource and which fail to generate efficient market signals about the true value of specific transportation services. In extremis, the approach could amount to constraining prices paid to a pre-determined level and a return to administered charges.

The value of the auction results as an investment signal have been widely questioned. Transco agree that a monthly capacity auction provides little additional information about the appropriate locations or timing for future investment, in part this is because the monthly capacity auctions provide short term signals. For this reason some, may debate the importance of the absolute values derived from an auction process. It perhaps remains for the auction to provide an efficient allocation mechanism of a scarce resource, for which differing valuations between competing shippers provides the critical information. The absolute valuation could be of secondary importance. An adjustment method that maintained price differentials between competing bids may be perceived to maintain an efficient allocation methodology, whilst accepting that the absolute valuations are of less value as an investment signal.

<u>Questions for Consultation</u>

Transco proposes that a mechanism should be established in future for adjusting revenue when the outcome of 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. However, a minimum charge of X should apply, in order to avoid being below the short run marginal cost of operating the NTS.

Views are also sought on the attractions of basing an adjustment methodology on the alternative options discussed in this paper. In particular, Transco see merit in a methodology that could adjust entry capacity bids by a common absolute amount.

Transco suggest this would be appropriate whenever the cumulative outcome of NTS auctions implies revenues in a formula year 25% greater or lesser than predetermined "target" revenue for the NTS tier.

The adjustment should be based on the assumption of returning revenue to within the 25% tolerance band within the formula year. Any remaining under or over-recovery should accrue within K and hence be reflected in the general level of transportation charges.

At present the Network Code specifies a 2-month notice period that would be required prior to implementing the appropriate adjustment. Transco would also welcome comment on the validity of the notice period for operation of an auction income adjustment methodology.

Transco would welcome comments on these proposals.