

## TRANSCO CONSULTATION REPORT ON PC60

### Re-balancing Revenue Raised by MSEC and Other NTS Auctions

#### 1. Transco's Initial Proposal

In PC60 Transco invited views regarding the issue of how transportation charges should be adjusted in the light of major deviations from formula revenue implied by the outcome of various NTS transportation service auctions. Transco sought views on three main options. These were adjusting:

- A. Transportation charges in general.
- B. NTS commodity charge.
- C. Accepted auction bids.

If respondents supported early implementation, Transco proposed that the most effective mechanism should be put in place by the time of the next round of auctions currently scheduled for August 2000.

#### 2. Summary

In total there were 23 responses. One respondent wished their response to be unattributed (referred to as UR - unattributed respondent). The other respondents were:

##### **Shippers or Suppliers**

Exxon Mobil	EXM
Scottish Power	SCP
Yorkshire Energy	YE
Conoco UK	CON
Powergen	PG
Dynegy UK	DYN
Marathon Oil UK	MAR
Total Gas Marketing	TOT
BP Gas Marketing	BPGM
Scottish & Southern Energy	SSE
British Gas Trading	BGT
National Power	NP
TXU Eastern Energy Trading	TXU
V-is-on gas	V-IS
Elf Gas and Power	EGP
Northern Electric	NE
Shell Gas Direct	SGD

##### **Industry**

Major Energy Users Council	MEUC
Association of Electricity Producers	AEP

UK Offshore Operators Association	UKOOA
Transco LNG storage	TLNG
Corus	COR

From the 23 respondents;

- Eleven supported option C exclusively (MAR, SSE, CON, EGP, TOT, EXM, BPGM, COR, AEP, UKOOA, MEUC), of which six expressed a preference for a uniform scaling back of bid prices (CON, EGP, EXM, BPGM, UKOOA, MEUC), whilst the remainder expressed no opinion.
- Three supported option B (YE, TXU, TLNG).
- One supported option A (SCP).
- One supported a hybrid approach with the total adjustment split between options B and C (BGT).
- Seven supported an option equivalent to creating a new “entry commodity” charge or rebate (SGD, NE, NP, V-IS, PG, DYN, UR).

### 3. Basic Rationale

Eight respondents (SGD, NE, SSE, NP, SCP, EGP, V-IS, TOT) expressed the view that there was a fundamental conflict surrounding the use of auctions as a means of allocating transportation services within the context of a regulated formula income. Despite this, eleven respondents (NE, MAR, SSE, CON, EGP, V-IS, TOT, PG, BPGM, TLNG, UKOOA) expressed support for the introduction of a specific adjustment mechanism by which deviations from formula income implied by auction outcomes can be removed. One respondent (SGD) however stated that any such adjustment mechanism was at odds with the use of market mechanisms to allocate scarce resources.

To reduce potentially undesirable effects of any adjustment, eight respondents (MAR, SSE, CON, NP, TXU, BGT, COR, UKOOA) explicitly expressed the view that it should be ring fenced within the NTS tier of transportation charges. Six (SSE, PG, CON, UKOOA, AEP, TOT) expressed the view that the adjustment should apply to the period covered by the auction outcomes that implied a deviation from formula income.

One respondent (BGT) expressed the opinion that it was important that whatever mechanism was put in place the rules should be obeyed in future in order to build trust and reduce uncertainty.

#### Transco’s Response

Transco understands respondents concerns regarding the conflict between market based solutions and regulated formula income, but accepts that auctions are an economically efficient means by which scarce resources can be allocated.

Transco welcomes the level of support expressed by respondents for the introduction of a specific adjustment mechanism which is both ring fenced within the NTS tier and timed to coincide with deviations from formula income.

### 4. Option A - Adjusting all Transportation Charges

Only one respondent supported this approach (SCP) arguing that it was the accepted method by which deviations from formula income were accounted for. However it did state support for a suitable alternative mechanism so long as it was in place before the next round of auctions.

This option was opposed by other respondents (SGD, SSE, NP, EGP, AEP), on the basis that it would discriminate against certain market sectors and shippers, due to its undesirable distributional effects. Other reasons for opposing this methodology included a belief that it would have implications for the principles of cost reflectivity (NE), and a feeling that it would unfairly benefit the largest shippers (V-IS).

### **Transco's Response**

Whilst "K" is the established mechanism by which variations from formula income are taken into account, it is Transco's view that developments in the gas transportation business, such as the NGTA, can create new requirements which should be addressed by changes to Transco's transportation charging methodology. This is consistent with the PGT Licence requirements.

Transco agrees with the majority of respondents that reliance on "K" would not be appropriate for significant revenue variations, and that such an approach could lead to market distortions and a reduction in cost-reflectivity. However, Transco believes that where the deviation from formula income is modest, adjustment of prices through "K" during the normal charge setting process is the most appropriate way forward.

## **5. Tolerance Limits**

Of the sixteen respondents that expressed a view only three (TLNG, EXM, SGD) felt that the adjustment mechanism should remove 100% of the revenue deviation implied by auction outcomes. The remainder felt that although the adjustment mechanism should remove the majority of any deviation, a residual should be taken account of by the existing "K" factor. Five respondents (SCP, EGP, TOT, TXU, AEP) favoured a tolerance level of ! 25% of auction target income. One respondent (CON) favoured a tolerance expressed as a percentage of total transportation income while another (PG) favoured an absolute amount rather than a figure expressed as a percentage. All other respondents that expressed an opinion (BGT, BPGM, MAR, UKOOA) favoured tolerance limits of between 5% and 25% of target income.

### **Transco's Response**

Transco believes that there should be a level of tolerance such that transportation charges are only altered following significant deviations from target revenue. A balance should be struck between a level of tolerance which minimises the undesirable effects of using the "K" factor mechanism, and a level which creates volatility in the level of charges. Following the consultation process Transco is of the opinion that a tolerance level of +/- 10% of target revenue from auctions would be appropriate.

Transco accepts that there is range of means by which tolerances may be expressed. It is Transco's view that a tolerance expressed as a percentage of auction target revenue is the most suitable since it is variations in auction revenue that are of concern.

## **6. Option B - Adjusting NTS Commodity Charge**

This option was supported exclusively by three respondents (YE, TXU, TLNG). and as part of a hybrid solution by one other (BGT). The major attraction suggested for this approach was its simplicity. Within the proposed hybrid approach, the NTS commodity charge would contribute 50% of the necessary adjustment, the remainder being accounted for by adjustments to accepted bids in the auctions.

The major criticism of this option related to the fact that at present the major transportation service allocated by auction is MSEC. It was argued that, because of gas trading at the NBP, there may be a discontinuity between an individual shippers' participation in the auction process and its exposure to the adjustment mechanism. Respondents suggested that any adjustment based on the NTS commodity charge could result in windfall gains or losses for different shippers (SGD, NE, MAR, NP, SCP, EGP, PG, BPGM, UKOOA, AEP). One respondent (NP) suggested however that price changes along other parts of the supply chain would reduce such effects.

Three respondents (CON, NP, UKOOA) suggested that the NTS commodity charge had limitations as an adjustment tool because downward movements are limited to a level equivalent to the short run marginal cost of operating the NTS. One respondent (TXU) suggested that in circumstances where this became a problem, then accepted bids could be adjusted as required. In a similar vein one respondent (MEUC) wondered how effective this mechanism would be if a more cost reflective 90:10 capacity commodity split was introduced.

Two respondents (CON, UKOOA) raised the issue of the Optional Tariff and how its benefits relative to the standard NTS commodity charge would vary as the level of the standard charge varied.

Other points raised by individual respondents included increased price volatility (UR) and the fear that this mechanism would unduly favour large shippers (SSE).

### **Transco's Response**

An adjustment to the NTS commodity charge could leave some distributional impacts between shippers, particularly between those shipping to the NBP and those shipping from it. Transco recognises the differing arguments put forward, but believes that it may be argued 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.

Transco believes that the NTS commodity charge offers a flexible balancing tool and that it is unlikely that a situation would develop in which it was incapable of removing a significant proportion of any deviation from target revenue. Transco would suggest that the use of the NTS commodity charge as a balancing tool within the NTS tier of transportation charges will in effect allow the market to determine the most appropriate capacity commodity split within that tier.

Transco's view is that the Optional Tariff 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 Commodity charge. For this reason the tariff itself should remain unaffected by the level of the standard charge

## **7. Option C - Adjusting Accepted Bids**

Eleven out of 23 respondents supported an adjusted bid solution, with all those that expressed a preference, six in total, favouring an aggregate approach rather than one which was location specific. Of these six, two (CON, UKOOA) expressed a preference for the use of a common absolute adjustment. Another three (EGP, BPGM, MEUC) expressed their preference for the application of a common proportionate adjustment. Advantages of an aggregated approach were cited as being the maintenance of price differentials as expressed in the auctions, and one respondent (TOT) additionally claimed that aggregation would help to prevent overbidding.

One respondent (BGT) supported this method as part of a hybrid approach under which adjustments to accepted bids would account for 50% of the adjustment necessary, the remainder being by means of the NTS commodity charge.

Three respondents (SGD, MAR, EGP) felt that this approach avoided many of the distributional problems associated with other possible mechanisms, since the adjustment would be concentrated at the source of the problem. However three respondents (NE, V-IS, UR) felt that this option would benefit larger shippers as it would make hoarding of any auctioned service more attractive.

The main criticism of an adjusted bid approach, as expressed by six respondents (SGD, NE, YE, TXU, V-IS, UR), was that it broke the pay as you bid principle and was therefore likely to lead to an upward spiral in prices. In general it was felt that such an approach could undermine the entire basis of the auction system.

Two respondents (SCP, V-IS) raised the issue of bids being scaled upwards in circumstances of under-recovery. SCP thought this would be unacceptable to smaller shippers, and V-is-on raised the question of how capacity would be got back to the community if shippers were not prepared to pay more than they had bid.

### **Transco's Response**

Transco recognises the argument that adjusting accepted bids could be seen as desirable in that it targets the area where the revenue difference arose, and that it offers the potential to neutralise any undesired or unanticipated effects from the auctions. However, it is likely to also neutralise the beneficial impacts which the auctions have been introduced to deliver, i.e. efficient market signals about the true value of specific transportation services. Transco also agrees with those respondents that suggest adjusting bids could undermine the basis of an auction approach.

If a methodology were implemented which involved adjusting bids, Transco believes that aggregation would be appropriate. This is because Transco has put forward a composite approach covering all transportation revenue generated via an NTS auction. Transco would not, for example, propose adjusting charges if revenue fell outside a target tolerance at some entry terminals, but not in aggregate, nor if only the proposed tolerance service auction revenue fell outside the target range.

Transco cannot say whether shippers would prefer to forego a service rather than have their bids increased as a result of a revenue shortfall. However, Transco would observe that if shippers' bids reflect their valuation of a service, it is logical to suggest that they would not wish to pay a higher price than that bid for a particular service.

## **8. Rebates Based on Gas Flowed**

At present the major transportation service allocated by auction is MSEC. Most responses concentrated on issues specific to MSEC rather than the issue of auctioned services in general. This led seven respondents to propose an "entry commodity" methodology which might only be applicable to income deviations associated with the MSEC auctions.

Under this proposal a new charge, equivalent to "entry commodity", would be created. The level of this charge or rebate would vary as necessary to remove any deviations from target implied by MSEC auction outcomes. Four respondents (NE, NP, V-IS, UR) argued that this mechanism would discourage hoarding in the MSEC auction. It was also suggested that the adjustment would be concentrated on those that actually used the service rather than those that had simply purchased an option to use. This, it was argued, would discourage the hoarding of MSEC and so would remove the disadvantages associated with this practice. Five respondents (SGD, NE, NP, V-IS, PG) suggested that if this mechanism were implemented then the new "entry commodity" charge should be adjusted on an aggregated basis in order to discourage a movement of flow to the most constrained terminals.

### **Transco's Response**

Transco believes that the introduction of a new charge or rebate in the form of "entry commodity" could be regarded as to some extent commoditising the charge for entry capacity, an option which has been rejected during the RGTA debates. Adjusting the commodity charge further down the gas chain can be regarded as distancing the adjustment from the auction outcome, thereby reducing the potentially distortionary impacts likely to be associated with any adjustment mechanism.

Transco would also emphasize that the aim of the mechanism proposed in PC60 was to introduce a general mechanism by which deviations from formula income arising from the allocation of transportation services by present and future auctions might be taken into account. Transco is not convinced, therefore, that an entry based solution is appropriate.

## **9. Notice Period**

Two respondents (SGD, SSE) opposed the proposal to reduce the notice period for changes in the level of charges from two months to one month, arguing that auctions should be timed such that the present notice period could be maintained. However, three respondents (SCP, BGT, UKOOA) expressed a favourable attitude to the change, so long as there was adequate prior warning of the change.

### **Transco's Response**

Transco believes it would be preferable for the timing of auctions to be such that the standard notice period specified in the Network Code can be achieved. This however, may not always be possible and so, as a precaution, Transco believes that the required notice period should be reduced to one month for auction related changes in the level of charges.

## **10. Future Auctions**

Two respondents (SSE, AEP) raised questions related to the proposed Tolerance or Inventory service auctions. One (SSE) wondered whether this auction would come under the ambit of the PC60 mechanism. It suggested that, if this was not the case, then appropriate arrangements should be put in place at the same time as the auction is established. The other respondent (AEP) proposed that any adjustment mechanism should favour shippers that were "good balancers".

### **Transco's Response**

The mechanism proposed in PC60 would relate to all present and future NTS transportation services allocated by means of auction, including the tolerance auction presently provided for in the Network Code.

## **11 General Issues Raised**

The following points were made by respondents regarding the present auction arrangements.

- Opposed to the auction process as the means by which MSEC is allocated. (SSE)
- Present arrangements contribute to the inflation of bids and the NBP price. (SGD)
- Longer-term MSEC auctions would provide better market signals. (NP)
- Present arrangements act as a barrier to entry and impose costs on the industry. (V-IS)
- Ofgem must regulate to stop large shippers hoarding MSEC. (V-IS)

### **Transco's Response**

Transco supports the use of a market-based system as a means of allocating transportation services. However, it is accepted that there should be further debate about the particular arrangements surrounding MSEC and future auctions, and Transco expects to facilitate this through the Network Code modification process

## **12. Conclusion**

Transco welcomes the high level of response to this consultation paper. While responses contain a variety of views, Transco notes the majority view that there should be an adjustment mechanism established specifically to cope with deviations from target revenue resulting from the allocation of transportation services by auction. While Transco also acknowledges that the majority of respondents favour an approach focused on adjusting accepted bids, Transco believes that such an approach could be regarded as undermining the auction process. For this reason it is proposed that, beyond a tolerance level, any adjustment be implemented though

the NTS commodity charge, with any residual element being carried forward within the existing “K” mechanism.

### **13. Transco’s Proposal**

Transco proposes that the mechanism described below should be established. If this is not vetoed by Ofgem, it is proposed that it should apply to the next round of transportation service auctions in August and September 2000, with an adjustment to the commodity charge being made if necessary with effect from 1 October 2000.

In a situation where the aggregate outcome of NTS transportation service auctions imply a deviation from target revenue of greater than ! 10%. Then the NTS commodity charge will be adjusted as necessary from the start of the period in which the auctioned service is provided such that the deviation from target revenue is reduced to ! 10%. This adjustment will also be subject to the constraint that the NTS commodity charge must be greater than or equal to 0.0022p/kWh (the short run marginal cost of operating the NTS).

To facilitate this mechanism the Network Code would need to be modified such that the normal period of notice for changes to the level of charges should be reduced from two to one month in cases where this mechanism is triggered, but with a shorter notice period for 1 October 2000 only.