TRANSCO CONSULTATION REPORT ON PC61

Monthly System Entry Capacity Floor Prices

1. TRANSCO'S INITIAL PROPOSALS

Transco consulted on proposals to amend the methodology for calculating floor prices for Monthly System Entry Capacity. The proposals included an amendment to the established methodology to take into account the quantities identified for sale in the Network Code. Transco also proposed the removal from the methodology of an adjustment in the floor price calculation that reflected an assumed 50/50 recovery of NTS capacity income from entry and exit charges.

2. SUMMARY OF RESPONSES

In total there were twenty two responses, seventeen from shippers, three from user associations, one from an offshore producers association and one from another BG company.

Shippers	Alliance Gas Ltd	AGL
	British Gas Trading	BGT
	BP Gas Marketing	BPGM
	Conoco	Co
	Dynegy UK	DUK
	Elf Gas and Power	EGP
	Exxon Mobil	ExM
	Marathon	Mar
	Northern Electric	NE
	Npower	Np
	PowerGen	PG
	Scottish Power	SP
	Scottish and Southern	SSE
	Shell Gas Direct	SGD
	Total GM	TGM
	TXU	TXU
	V-is-on	V-Is
User Associations	AEP	AEP
	MEUC	MEUC
End Users	Corus	Corus
Offshore Producers Assoc.	UKOOA	UKOOA
Other BG Companies	Transco LNG	LNG

Nine respondents (BPGM, ExM, LNG, AEP, UKOOA, TGM, SSE, BGT, EGP) supported Transco's proposals, though a number did wish to qualify that support by indicating that they would in principle prefer floor prices to be set at zero.

3. COMMENTS RECEIVED

3.1. Zero floor price

Eleven respondents (SSE, NE, V-Is, BPGM, Np, Co, UKOOA, AGL, DUK, Mar and SSE) indicated that they would prefer the methodology to be amended to allow floor prices to be set at zero. One shipper (BPGM) had indicated that in principle it believed that floor prices for Monthly System Entry Capacity should be set at zero, but surmised that it may be more reasonable to discuss zero floor prices within the context of Transco's formula review for 2002. Five respondents (PG, Co, AGL, TXU and Np) are of the opinion that if the proposed revenue adjustment methodology contained in Pricing Proposal PC60 is not vetoed, then there would no longer be a need for floor prices in entry capacity auctions.

Four respondents (Np, V-Is, Co, Mar) are unsure whether entry capacity prices would have cleared above the floor price levels if the floor prices had been removed, with one of them surmising that floor prices prevent the true value of capacity from being revealed. One respondent (UKOOA) suggested that the present floor prices make it certain that Transco will recover its formula income, consequently making it necessary to create a revenue redistribution methodology.

3.2. Increased discount from Administered charge

One shipper (V-Is) suggested that floor prices should be set at a minimal level. Failing that, it suggested that the discount from the administered charge rate should be 50% at all locations except non competitive entry points. Another respondent (TXU) indicated that floor prices should be reduced a further 25% from proposed levels.

Transco's response

In accordance with BG plc's licence conditions Transco must set floor prices at a level which:

- Promotes efficiency in the supply of transportation services;
- Avoids undue preference in the supply of transportation services; and
- Promotes competition between suppliers and shippers.

Auctions promote competition for the products on offer and enable those products to be gained in a non-discriminatory manner between competing parties. In Transco's view, essential requirements of a non-discriminatory auction are measures to mitigate against potential abuse of market power. To that end floor prices are a standard means of preventing the impact of dominant players exercising market power. This requirement may be considered to be particularly relevant for a regulated monopoly such as Transco where revenue shortfalls resulting from an auction may be expected to be paid for by increasing charges elsewhere on the transportation system. By this means a dominant shipper could pass on costs to competitors by gaming an auction. Market power and its abuse is difficult to measure, but it is accepted that in the case of auctions familiarity with the auction process will increase the risk of abuse. Transco therefore holds a view that evidence from only two sets of auctions of Monthly System Entry Capacity is insufficient to conclude that there is no potential abuse of market power in the future. Moreover, analysis of shipper capacity holdings at each terminal indicates sizeable concentrations of capacity in comparatively few hands at all terminals.

A number of respondents have indicated that if the floor prices are reduced or removed then income from the auctions will reduce. This, it is suggested, is a desirable outcome because it will correct for past over recovery against formula income. Transco agrees that bids are probably formulated with some consideration for the prevailing floor prices. It follows that a different set of floor prices could produce a different outcome in the auctions, whilst satisfying the same inelastic demand. However, that in itself is not sufficient reason for reducing floor prices - consideration should be given to efficiency in the supply of all transportation services. It is possible that greatly reduced floor prices could result in an under recovery of formula income. Transco would then seek to raise other transportation charges to correct for the under recovery. A compensatory increase in NTS commodity charges, for example, would be expected to raise transportation costs for shipping to high load factor customers such as power stations and industrial consumers. Increased costs for these consumer groups may provoke a degree of load shedding which would be inefficient because the income adjustments resulting from low floor prices could reduce demand for other consumer groups elsewhere on the transportation system.

3.3. Revenue Volatility

One respondent (Co) expressed an opinion that the present floor prices are undesirable because shippers are forced to bid higher prices which increases the risk of volatile bid pricing. Another respondent (V-Is) suggested that floor prices would help to mitigate against instability arising from auctions.

Transco's response

Transco agrees that prices resulting from auctions can be volatile and recognises that this is a source of concern to shippers. However, Transco believes that floor prices should tend to mitigate against a degree of volatility because it is probable that floor prices will tend to flatten out a typical bid stack. That is, large quantities may be bid for at or near to the floor price and progressively smaller quantities at higher prices.

3.4. Removal of 50/50 provision

Of those respondents that commented directly upon the proposal to discontinue the prior assumption of an equal income stream from entry and exit capacity, one (TGM) supported and one (BGT) did not support the proposal. Another respondent (DUK) asked for a more detailed explanation of the reasons behind this aspect of the pricing proposal. The respondent that did not support this aspect of the proposal did so because it appeared that it could change the source of a proportion of Transco's revenues.

Transco's response

A key component of the floor price methodology is the administered charge calculation which is based upon a long run marginal cost methodology (LRMC). During the calculation of those LRMCs a full matrix of costs from every NTS entry to every NTS exit point is converted into a single cost for each entry and exit point. The rationalisation of the full matrix to a single cost at each location is achieved by the application of a regression methodology. The regression process aims to minimise the sum of differences that arise when comparing the full matrix cost of a transportation route with the sum of a single entry and exit cost. The division of costs resulting from the regression process does not exactly equate to an equal split between entry and exit because a 50/50 split is not aconstraint on the regression methodology. In the event, the results typically approximate to a 50/50 split; though the actual outcome will change year on year. Following recent auctions, Transco recognised that where auctions clear above the floor price, the cleared prices may not be that sensitive to the minor adjustments in floor price levels that is implied by application of this aspect of the methodology. As a consequence Transco concluded that the methodology could be simplified by removal of the 50/50 provision with negligible impact on prices paid in the auction

3.5. Non-competitive terminals

A number of respondents offered support for the provision in the present methodology which maintains a higher level of floor price at non-competitive terminals than would otherwise be the case for terminals that display a satisfactory degree of competition. One shipper (SP) offered an amendment to this aspect of the methodology whereby the applicable floor price at non-competitive terminals would be benchmarked to the auction outcomes at the other terminals. Another respondent (BGT) questioned the validity of treating non-competitive terminals in a manner that is different from other locations. They put forward a hypothesis that if the amount of capacity being sold in the monthly auctions increases towards peak levels then most terminals could be expected to clear at, or near to, their floor prices. The same respondent is also concerned that, particularly in instances of zero floor prices, the non competitive terminals may also have to bear part of any apportionment resulting from an under recovery of entry capacity revenue elsewhere.

Transco’s response

Transco is pleased to receive suggestions on this aspect of the floor price methodology. Pricing at non competitive terminals and the definition of a non-competitive terminal remain a source of concern to Transco. Benchmarking prices at non-competitive locations to the auction results at other terminals raises a number of interesting issues. Not least is the determination of the appropriate mix of prices produced at other locations. This form of price determination appears to require auctions at competitive terminals to be held before capacity can be allocated at the non-competitive terminal. In order to facilitate this a quantity of capacity would need to be held in reserve for use at those non-competitive terminals without actual demand being necessarily revealed. In the auctions of September 1999 a significant quantity of capacity remained unsold at Barrow for a number of months. Provisions are now in place for excess capacity to be offered for use at other terminals where demand is unsatisfied. This aspect of the Monthly System Entry Capacity auction process was implemented through Network Code Modification proposal 0371, implementation of which introduced an additional round of auctions for previously unsold capacity.

Transco notes the observation that if the capacity allocation at each terminal is increased beyond the normal demand for that product then auctions will tend to clear at the floor price. If that is the direction that the provision of capacity is moving towards, then Transco would contend that there is a need for floor prices that are at or close to cost reflective levels in order to prevent unnecessary distortions of other cost reflective transportation charges. Based on the present capacity allocation, auctions at competitive terminals may be expected in the main to continue to clear at levels above the floor price. That has not been the case at non-competitive terminals where bids for capacity have been placed at the floor price and no higher.

3.6. Seasonal Floor Prices

One respondent (SSE) requested that Transco should explore the possibility of introducing different floor prices in each month to reflect seasonal demand and hence the difference in value for entry capacity.

Transco's response

When the present methodology was developed, Transco recognised that there could be a case for developing seasonal floor prices. It was anticipated that the auctions held in September 1999 and March 2000 could provide information for developing such a methodology. In the event, recent prices have indicated that floor prices could, if anything, be set higher in summer than winter. That outcome may be regarded as counterintuitive to a widespread assumption that demand, and therefore prices, would tend to be highest in winter. Given, this uncertainty Transco does not feel confident that sufficiently robust information is available for developing seasonal floor prices.

4. TRANSCO'S FINAL PROPOSALS

Transco recognises the concerns expressed by a number of respondents that floor prices should not prevent an efficient allocation of entry capacity. However, Transco believes that floor prices play a valuable role in protecting from market dominance, which respondents generally supported in the case of terminals with limited competition. It is therefore Transco's view that floor prices promote efficiency in the supply of transportation services, as required by the PGT Licence. In addition Transco believes that floor prices provide a "safety net" which helps to limit any potential revenue shortfall. This can help to avoid the need to adjust other transportation charges were a revenue shortfall to be experienced. Transco believes this is consistent with the PGT Licence requirement to set reserve prices at a level which is best calculated to avoid undue preference in the supply of transportation services.

In the light of the consultation Transco's final proposals are that the floor price methodology to be applied to Monthly System Entry Capacity that is used from 1 October 2000, should be amended such that:

- **Floor price calculations take into account the quantities that have been identified for sale in the Network Code and**
- **The adjustment for an assumption of equal revenue recovery from NTS entry and exit capacity should be discontinued.**