Direct Dial: 020-7901 7327

24 August 2001

Transco, Shippers and Other Interested Parties

Our Ref: PC65

Dear Colleague,

Pricing Consultation 65

Ofgem has decided not to veto Pricing Consultation (PC) 65, '*Alternative Method of Funding Entry Capacity Constraint Management*'. The reasons for this decision are set out in the accompanying paper.

Transco has submitted a report in respect of PC65 to the Authority, and has requested the Authority's approval of the implementation of the proposal set out in that report notwithstanding that 28 days have yet to elapse from the furnishing of that report to the Authority. The Authority has decided to grant such approval.

This proposal, which was revised following consultation, adjusts the existing revenue adjustment mechanism (established through PC60, *Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions*).

If auction revenues exceed target revenues by more than 10%, then Transco will use any excess revenue to rebate transportation charges to MSEC holders in the event that buy back costs are incurred. The excess revenue will be divided in to six equal monthly amounts. In the event of buy back costs, a rebate to MSEC holders will be made to offset MSEC holders' exposure to that proportion of buy back costs not paid by Transco under its incentive scheme. Any over-recovery not rebated in this manner (for example if no buy-back costs are incurred) will be rolled in to the next month's fund. If at the end of the six months, a proportion of the excess revenue has not been rebated, it will be reflected in the general level of transportation charges, as under the existing methodology.

In the event of an over-recovery, the NTS commodity charge would not be reduced and with effect from 1 October 2001, it would be set at 0.0136p/kWh.

If you have any questions on this letter, or the accompanying paper, please do not hesitate to contact me on the number above, or Mark Feather on 020 7901 7437.

Yours sincerely,

Steve Smith
Director, Trading Arrangements

<u>Ofgem's views on Transco's Proposal for an Alternative Method of Funding Entry Capacity Constraint Management (PC65)</u>

Introduction

Transco circulated PC65 for consultation on 30 July 2001, following Ofgem's agreement to permit a reduction to the consultation period applicable under Amended Standard Condition 4(2)(a) of Transco's Gas Transporter Licence, from 28 days to four days.

The current arrangements for 'Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions' (PC60)

Following PC60, '*Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions*', the revenue adjustment mechanism which operates in the event of an under or over-recovery of revenues against target revenue from the auctions of entry capacity is as follows:

- There is a 'dead-band' of ± 10 per cent for auction income to deviate from target revenue under the price control. This amount is used to adjust the general level of transportation charges – sometimes referred to as the 'K' adjustment factor;
- Where the deviation is greater than 10%, National Transmission System (NTS) commodity charges are adjusted, subject to a minimum level (0.0022 p/kWh); and
- any remainder results in a further 'K' factor adjustment.

As a result of application of this adjustment mechanism, NTS commodity charges are currently at the minimum rate and since 1 June 2001, all other transportation charges have been subject to a 15% reduction.

Transco's initial proposal

The initial modification proposal provided for an alternative to the current arrangements (as outlined above). The main features of the proposal were as follows:

- Prior to each six-month auction period, Transco will forecast the likely buy-back costs in that period;
- These costs will be included in the calculation of target revenue from NTS auctions;
- Following the completion of any auction, first the NTS commodity charge and then transportation charges in general will be adjusted, so that any deviation from target revenue is removed;
- At the end of the auction period, any residual monies left in the buy-back fund will be distributed on the basis of MSEC holdings and excluded from the calculation of 'K'.

Respondents' views

A large majority of respondents did not support this proposal. Some of these respondents nevertheless recognised the strength of feeling within parts of the industry that the redistribution mechanism was inequitable and saw some merit in the proposal, but could not support it because of a number of concerns. The main concerns with the proposal are outlined below.
A number of respondents opposed to the proposal did not regard the timing of this consultation as appropriate, given its proximity to the upcoming auctions, which one respondent said could have a volatile effect on the capacity market. Another respondent said that the proposal would significantly damage competition in gas supply by making it more difficult to compete and quote for new customers. Other respondents said that it should be considered as part of the discussions to find a longer-term solution where all the issues can be fully identified and debated. Some respondents said that an enduring solution was likely to emerge from consideration of Ofgem's proposals for the reform of the NTS entry, exit and gas balancing regime.

A number of respondents were unclear as to whether the proposal necessitated a change to Transco's Gas Transporter's Licence. If it did, respondents recognised that the proposal was not feasible because there was not sufficient time in which to effect a Licence change ahead of the forthcoming auctions. A number of respondents thought that the proposal necessitated a licence change because it involved significant changes to the incentive scheme.

A number of shippers said that Transco would have great difficulty in estimating the cost of future buy-backs because it would be difficult to predict how shippers would value capacity on any given day. These shippers said that past experience might not be a good indicator of the future because of potential changes to the regime and differences in the nature of constraints and valuations of capacity. Respondents' argued that Transco would be under pressure to over-estimate the size of the fund in order to ensure that there was no over-recovery remaining and one of these respondents said that the proposal was unclear about how any excess remaining in the fund would be used. Other respondents said that any Transco forecasts would need to be transparent and easily auditable. One respondent said that the size of any fund should be dependent on the size of any over-recovery.

A number of respondents questioned the necessity of making adjustments to transportation charges. One of these respondents did not support the proposal on the basis that it was likely that a substantial part of any over-recovery could flow back through reductions in transportation charges downstream of the NBP, which it said would result in discrimination between different classes of shippers and would affect bidding behaviour. Another respondent said that the proposal did nothing to reduce the risk of volatile transportation charges.

A number of respondents strongly expressed the view that an incentive mechanism on Transco was necessary in order to reduce buy-back costs and to invest and were concerned that this proposal removed Transco's buy-back incentive. In addition, one respondent, while supporting the proposal, said that it was necessary to structure the proposal in such a way that it only captured the expected level of shipper buy-back costs, while compensating Transco for the additional risks of buy-back.

Some respondents raised the issue of how the proposal would operate post April 2002, when there would be differing periods of capacity offered for sale. They said that, assuming annual (or longer) auctions for capacity, this would imply reconciliation at least 14 months after the auctions had taken place, causing severe cash flow implications for shippers.

One respondent also said that Ofgem should disregard inaccuracies in funding estimates of buy-back costs in measuring Transco's performance against its obligation not to over or under recover at the end of each formula year.

A number of respondents raised an alternative suggestion, of placing any over-recoveries resulting from the forthcoming auctions into an ESCROW account, allowing a solution to be implemented after the auction process, after adequate consultation. One of these respondents also said that the 'investment fund' proposal discussed in workstream meetings would have been more effective in addressing the problems attempted by the proposal.

A number of respondents raised a concern that the creation of a buy-back fund would impact on shipper buy-back prices. One such respondent said that shippers who contributed to an auction over-recovery would want to ensure that, given the opportunity to sell capacity back to Transco, they received as high a price as possible to compensate them for the initial high capacity prices. Other respondents said that consideration of this proposal should await the outcome of Ofgem's investigation into buy-back prices.

One respondent said that recent over-recoveries have been much greater than the amount of buy-backs and therefore questioned the effectiveness of the proposal in its attempt to resolve the problems of over-recovery. Another respondent said that, in the event of a significant over-recovery, any additional revenues not required for buy-backs would be redistributed in the normal way, which would replicate the existing distortions.

One respondent said that the proposal should not apply in the event of an under-recovery of revenues. It said that an under-recovery implied that there was little shortage of capacity and Transco would be unlikely to require a buy-back fund in such situations. Another respondent said that increasing commodity charges as a result of an under-recovery was not an improvement over the current regime.

One respondent said that the proposed reconciliation process, whereby in the event of an over-recovery or an under-forecast of the level of buy-backs, may expose MSEC holders to one hundred per cent of buy-back costs, which would have major cashflow implications for MSEC holders.

One respondent said that, whilst reducing the smearback of buyback costs appears less discriminatory than a reduction in exit charges, this method of redistribution was still not market neutral because it is not allocated on a terminal specific basis.

One respondent suggested an alternative approach of scaling back successful bids for NTS entry capacity once NTS commodity charges had been reduced to the minimum level specified in Transco's pricing methodology, in order to redistribute over-recovered funds back to those shippers who have paid excess NTS entry capacity charges.

Respondents who supported the proposal regarded it as a short-term solution only. One of these respondents saw the proposal as a short-term fix to the problems of inequitable distribution of revenue and distortion of bidding behaviour, but one which, together with implementation of Modification Proposal 0481, may 'provide insights into the viability of longer term arrangements for a top down approach to capacity allocation, longer term capacity and the scope of Transco's constraint management activities'.

Transco's revised proposal

Transco recognised that, while a majority of respondents did not support the modification proposal in its original form, there was support for the concept of a buy-back fund. It therefore suggested a modified approach, to apply from 1 October 2001, with the following features:

- If auction implied revenue is above, but within 10% of, the target level, there will be no automatic offsetting adjustment to transportation charges;
- If auction implied revenue is more than 10% above the target level, Transco will calculate the level of this excess revenue;
- The excess revenue will then be divided by six in order to establish monthly amounts;
- For any month where the excess amount exceeds aggregate buy-back costs charged back to shippers, the excess amount for the following month will be increased by the amount by which the excess exceeds aggregate buy-back costs charged back to shippers; and
- Transco will reduce each MSEC holders' entry capacity charges by a share of the lower of the excess or buy-back costs charged back for the relevant month, with that share based on the proportion of aggregate MSEC held by the shipper concerned in the relevant month, subject to that share not exceeding its unadjusted entry charge.

Any over-recovery not rebated according to this methodology will be dealt with through adjustments to the general level of transportation charges, as under the existing methodology.

Ofgem's views and reasons for decision

Transco has submitted a report in respect of PC65 to the Authority, and has requested the Authority's approval of the implementation of the proposal set out in that report notwithstanding that 28 days have yet to elapse from the furnishing of that report to the Authority. The Authority has decided to grant such approval.

In reaching this decision, Ofgem has given careful consideration to the views put forward by all respondents during the consultation process. Ofgem shares the concerns raised by respondents about the short time period allowed to consider this proposal and indeed the other modification and pricing consultation proposals that have preceded the forthcoming winter capacity auctions. In this regard Ofgem would encourage Transco in future to try to ensure that proposed amendments to Transco's pricing methodology are conducted in a timely manner well before the auctions are due to start.

Ofgem accepts that in revising its proposal, Transco has sought to address many of the concerns raised by respondents. Transco's revised proposal will see the effective creation of a fund to offset buy-back costs incurred and charged back to shippers, in the event of an auction over-recovery.

The revised proposal will not require a licence modification to implement, a key concern raised by respondents. It will not require the suspension of Transco's incentive arrangements, another key concern raised. The revised proposal also avoids the need for Transco to make an ex-ante forecast of the size of the fund, another concern raised by many respondents. The revised proposal will not lead to an increase in the NTS commodity charge to fund buy-backs in the event that the auction under-recovers.

In the event that significant buy back costs are not incurred and the auction over-recovery is not rebated in this manner, the over-recovery will continue to be rebated through a general reduction in transportation charges as under the existing methodology.

Ofgem is therefore satisfied that in revising the proposal, Transco has sought to address the key concerns highlighted by respondents. Ofgem supports the principle that in the event of an over-recovery, any excess revenue should be used to offset

MSEC holders' exposure to that proportion of buy back costs not paid by Transco under its incentive scheme.

In accepting this proposal, Ofgem wishes to emphasise that an enduring solution to addressing any future over or under-recoveries associated with MSEC auctions will be needed for the period beginning April 2002 as part of the process of developing the framework for long term investment in the NTS.