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TRANSCO Pricing Consultation Paper PC 65

Alternative Method of Funding Entry Capacity Constraint Management

SUMMARY

Transco at present makes monthly volumes of System Entry Capacity available for allocation by auction. If the auction revenue is considerably over or under target revenue then a countervailing adjustment is made to the NTS commodity charge for the same period. Transco is incentivised to make entry capacity available on a daily basis and to minimise the effect of capacity constraints on a daily basis through a capacity buy-back process. Income and costs from the daily processes contribute to an incentive mechanism by which it retains some of the additional revenue or bears some of the buy-back costs, with the balance of the daily revenue or costs going to shippers.

In light of ongoing discussions regarding the treatment of auction over-recovery Ofgem have recently raised the issue of linking entry capacity buy-back requirements and treatment of auction over-recovery. This Pricing Consultation Paper takes that idea forward and proposes a methodology by which the adjustment of revenue following auction outcomes and the incentives for daily capacity sales and buybacks may inter-operate in a cost reflective manner. The aim of the paper is to establish a methodology, if appropriate, to apply to auction over-recovery revenues for the period October 2001 to March 2002 and thereafter.

The proposal is that a fund should be established and will be financed by income from Monthly System Entry Capacity Auctions (MSEC). The size of fund is subject to an estimate by Transco of the scale of costs likely to be incurred for capacity buy-back during the period covered by the relevant MSEC auction. At the end of the period an adjustment invoice will be sent to all holders of MSEC to correct for imbalances in the fund requirements over the period. The funding requirements for capacity buy-back will be considered prior to making any adjustments to transportation charges that would otherwise be necessary to correct for over or under recovery of auction income.

Alternative Method of Funding Entry Capacity Constraint Management

1. INTRODUCTION

In each of the last three sets of auctions of Monthly System Entry Capacity, the auction income has substantially exceeded the target revenue. As a result, post-auction adjustments have been made to the level of charges. During October 2000 Transco bought back significant quantities of MSEC from shippers at substantial cost. The majority of these costs are met by shippers. The impacts of both these mechanisms have distributional effects between shippers which depend on their relative position at the ASEPs at which buy back is required and the system as a whole.

It has been suggested by a number of shippers that alternative adjustment or cost allocation arrangements should be introduced, and in particular that there should be a direct link between the primary capacity auction outcome and the daily incentive mechanism, which would reduce the perceived unwelcome distributive effects of the present arrangements.

2. THE PRESENT ARRANGEMENTS

Under present arrangements Entry Capacity is made available under two separate regimes:

- A regulated regime with allowed revenue covering Monthly (firm) and Interruptible System Entry Capacity, (MSEC and MISEC).
- An incentive regime covering income from Daily (firm) and Interruptible System Entry Capacity (DSEC and DISEC) sales and the costs of buying back monthly capacity on a daily basis.

2.1 THE REGULATED REGIME

The target income to be raised from the sale of MSEC and MISEC is derived from the forecast total allowed transportation revenue (set by special condition 9c of the Public Gas Transporter (PGT) licence) and the prevailing methodology for NTS charges (capacity/ commodity split, LRMC-based charges). However auction outcomes are uncertain and so the income may be above or below target. Transco's PGT licence requires it to take all reasonable steps to avoid over recovery of transportation income in a year. The following adjustment process has therefore been established following Pricing Consultation paper PC60. Where the aggregate income from the auctions is expected to deviate from target revenue by more than 10% then the NTS commodity charge is adjusted as necessary such that the deviation is reduced to 10%, subject to a minimum rate of 0.0022p/kWh which is equivalent to the short run marginal cost of operating the NTS.

The charge is currently at 0.0022p/kWh and will continue at that level until 30th September 2001. From 1 October it will revert to the provisional rate of 0.0160p/kwh reduced by the 15% general reduction, equivalent to 0.0136p/kwh but will be subject to the appropriate adjustments depending on the outcome of the August/September auctions. If income is still forecast to be above target following any commodity charge adjustment then a general adjustment in all transportation charges is applied, known as the K-adjustment factor. The most recent adjustment to transportation charges arose following the auctions of February 2001 whereby a 15% reduction in transportation charges was applied from 1 June 2001. The reduction applies until 31 March 2002 when the charges will be reviewed in the light of the new Price Control starting in April 2002.

2.2 THE INCENTIVE REGIME

An incentive arrangement has been established for incremental sales of entry capacity and constraint management of firm capacity rights. The Incentive captures all incremental sales and buy-back costs that occur within 42 hours of the relevant gas day. Broadly the capacity incentive is intended to encourage Transco to maximise the provision of capacity and for it to minimise the frequency and extent of constraints. Shippers share in these incentive arrangements as a recognition of a common stakeholder interest in the efficient operation of daily release and constraint management processes.

If on a daily basis Transco is able to provide additional capacity, it is allowed to retain 20% of this extra income, the other 80% being returned to the shipper community on a terminal specific basis. However, if Transco has to buy back capacity, it is liable for 20% of this extra cost, the other 80% being met by the shipper community but on a non-terminal specific basis.

There is both a monthly cap on the extra income Transco can earn from sales, and collar on extra costs imposed on Transco by buy back, beyond which the shipper community accounts for 100% of the extra income or costs.

3. THE PROPOSAL

It is proposed that a new cost reflective fund is established that reflects costs incurred through constraint management (buy-back) processes for entry capacity. Operation of the fund will require Transco to make a forward-looking estimate of costs likely to be incurred for constraint management for the period covered by auction. The proposal may best be considered in stages:

a) The fund will be drawn from auction income and will be sized to match the discrete period covered by the relevant MSEC auctions. For example, a cost estimate is required for the period 1 October 2001 through to 30 March 2002 in order to set aside the necessary funds following the auctions of summer 2001.

b) The fund will draw upon auction income prior to consideration of any necessary post auction adjustments required to achieve transportation income targets. If required an adjustment is applied to the NTS Commodity charge and possibly a wider adjustment to general transportation charges (the K adjustment).

c) In recent MSEC auctions, income has been above target but there is no guarantee that this will always be the case. This proposal is for the requirements of a buy-back fund to be considered prior to any calculation of over or under recoveries. In circumstances of under recovery which have perhaps been prompted by an increased primary allocation of capacity then the NTS commodity charge would be adjusted upwards to address both a reduced auction income and an increased expectation of buy-back costs.

d) A reconciliation invoice will be issued two months after the end of the relevant capacity period. The invoice will reflect the difference in actual expenditure at the end of the period from forecast expenditure when the fund was set aside. Settlement will be on a pro-rata basis amongst all MSEC capacity holders for the relevant period. For example, for the period October through to March an invoice will be issued in May, which will be issued to individual shippers on the basis of their percentage holding of all MSEC capacity issued for the period 1 October 2001 through to 30 March 2002.

e) Issue to shippers of the present buy-back capacity invoice will be suspended.

f) For the purposes of auditing Transco's requirement not to over or under recover against its PGT licence formulation any residual quantities arising from the fund will not be taken into account by GEMA under its powers to direct that this specific formulation of the licence is not taken into account.

4. DISCUSSION

4.1 REGULATORY ISSUES

Special Condition 9c of Transco's PGT Licence contains a definition of transportation revenue which indicates that cost elements that provide economic incentives to the licensee (Transco) and concern sales or buy-back of capacity rights within 42 hours of the day of use shall not be counted as transportation revenue for the purposes of Special Condition 9c. This suggests that a licence change would be required if capacity buy-back is to continue to act as an incentive upon Transco but that only the shipper portion of buy-back costs is funded from MSEC auction income. Transco believes that the proposal as presented removes capacity buy-back from the incentive process and so it is argued all buy-back costs should be counted against transportation revenue.

4.2 DISTRIBUTIONAL IMPACT

Under the present incentive regime, the distributional impact of the terminal-specific pass through of revenue derived from the sale of additional capacity depends upon the specific circumstances of each shipper. The pass through of costs derived from buy back of capacity is not terminal specific, since it is impossible to attribute the need for buy back at a terminal to any specific portion of the network, and so will have a different distributional impact.

In instances of over-recovery, any scheme to inter-relate buy-back costs with MSEC auctions are de-facto containing the cost effects to the NTS and specifically to those shippers who obtain entry capacity. After the buy-back provision is made then adjustments are made progressively to the NTS commodity charge and possibly a general adjustment to all transportation charges may be required.

In instances of under-recovery, The NTS commodity charge will be increased. In circumstances of either under or over recovery it is not possible to assess the interaction of the adjustments described above with individual shipper gains through the buy-back process.

5. CONCLUSION

Transco believes that the issue of whether the present mechanism for dealing with large deviations of primary auction income from target and the structure of the incentive mechanism relating to daily capacity buybacks and sales should, in some way, be inter-related is worth consideration. Transco has put forward this Pricing Consultation to further understanding of the issues and if possible to gain implementation of a satisfactory Pricing Methodology.

QUESTIONS FOR CONSULTATION

Views are invited on the appropriateness of establishing a buy-back fund on a cost reflective basis and to which MSEC auction income in excess of the target will contribute. In addition a reconciliation invoice will be issued at the end of each relevant period. The relevant period being the period for which MSEC capacity was auctioned when the cost estimate was made. In addition to general comments upon the appropriateness of the proposal responses would be appreciated upon the following specific areas:

- **Should the fund reflect buy-back costs of both shippers and Transco?**
- **Should cost estimates be made on forward looking or on a retrospective basis?**
- **Should the fund allocation be made prior to consideration of Auction performance against formula targets?**
- **Should the fund provision apply equally to conditions of under and over recovery?**
- **Should GEMA disregard inaccuracies in funding estimates for buy-back costs when measuring Transco's performance against its obligation not to over or under recover at the end of each formula year?**