August 2001

TRANSCO CONSULTATION REPORT ON PC65

Alternative Method of Funding Entry Capacity Constraint Management

1. Transco's Initial Proposal

In PC65 Transco sought views on a proposed mechanism for funding the costs of entry capacity constraint management (buy-back). The main outline of the proposal was 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
- These residual monies will be excluded from the calculation of "K".

This report sets out the views received from the community and Transco's response.

2. Summary

There were 16 responses to the consultation paper. Two of the respondents wished their responses to be unattributed. They are referred to in the text as UR1 (unattributed respondent) and UR2. The other respondents were:

Shippers & Suppliers	
Alliance Gas	AG
BP Gas Marketing	BPG
British Gas Trading	BGT
Conoco	CON
Exxon Mobil Gas Marketing	MOB
Innogy	INN
Northern Electric	NE
Powergen	PG
Scottish & Southern Energy	SSE
Shell UK	SHE
Shell Gas Direct	SGD
Total Fina Elf	TOT
Other Interested Parties	
Association of Electricity Producers	AEP
Corus	COR

- One respondent wanted the creation of a buy-back fund immediately. (BPG), while another (UR1) thought that it should be introduced in conjunction with Network Code Modification Proposal 0481.
- Four respondents (AG MOB CON TOT) although supportive in principle believed that any over recovery should be placed in an ESCROW fund until the precise details of a scheme were established.
- Ten respondents (AEP COR BGT INN PG NE SSE SHE SGD UR2) rejected the proposal.

3. Detailed Responses

3.1 Timing Issues

A number of respondents expressed dissatisfaction with the shortened consultation period (AG BPG CON SSE SGD UR2 NE) believing that it did not provide sufficient opportunity for the community to fully consider the proposals. Three respondents expressed the opinion that it was too close to the opening of the next set of MSEC auctions to be making major changes to existing methodologies (BGT SSE UR2).

Four respondents (AG SSE NE SGD) also felt that the uncertainty surrounding the precise nature and quantity of entry capacity to be made available in the August 2001 auctions made it impossible to express a definitive view. Indeed it was such issues that caused two respondents (AEP NE) to reject the proposal. A third (SSE) expressed the view that the proposal could only be properly considered in the light of the Ofgem investigation into buy-back costs.

Transco's Response

Transco recognises that a short consultation period is not an ideal situation, but would offer the observation that the proposed mechanism has been discussed previously, and therefore the issues surrounding it were known to the community. Transco considered that in raising this Pricing Consultation it was responding to a request made at an RGTA meeting to consult on the possibility of using auction receipts to fund capacity buy-back costs. In this respect, Transco does not believe that the precise nature and quantity of entry capacity to be made available in the August 2001 set of auctions has any significant bearing on the fundamental arguments surrounding the proposal.

3.2 Licence Requirements

Many respondents expressed a view on this issue (NE AEP SGD UR2 TOT PG INN CON SSE AG BGT MOB). While some were unsure, none suggested that the proposal could or should be introduced without a Licence change.

Transco's Response

Transco recognises respondents concerns that any proposed changes should be properly reflected in Transco's PGT Licence. With regard to the licence issues raised by this proposal, Transco's interpretation of Special Condition 9C of its Licence is that revenue from Monthly System Entry Capacity auctions is captured in Transportation Revenue within the terms of the price control as set out in the PGT Licence. This revenue is measured on a gross basis and does not appear capable of being reduced by debits or payments made to shippers for other purposes.

The Licence also specifies that the only auction revenue that can be considered to be outside the formula is that relating to "the sale or purchase of rights to put gas into its pipeline system within 42 hours of that sale or purchase other than Monthly System Entry Capacity". This revenue is dealt with in the capacity incentive mechanism within the Network Code.

3.3 Transco's Capacity Incentive Regime

All respondents that expressed an opinion (AG CON BGT SSE PG UR2 BPG SHE TOT AEP NE) were of the view that Transco should continue to be liable for a proportion of future buy-back costs, and one (BPG) felt that this should be increased. Without financial penalties the belief was that Transco would increasingly utilise buy-back. One respondent (SHE) worried that the lack of an incentive scheme might lead to under investment in the provision of entry capacity.

Transco's Response

Transco recognises the concerns of respondents. In putting forward this proposal it sought to find a methodology that could be implemented in a timely fashion and consequently would avoid the need for a significant PGT Licence modification. In that regard Transco failed to find an acceptable proposal that would enable allowed revenue to be set aside to fund shipper buy-back costs whilst maintaining an incentive on Transco. Transco had therefore put forward a proposal that sought to circumvent the definition of incentive income by effectively re-defining all buy-back costs as allowed revenue. Transco would also emphasise that it would not envisage any such arrangement continuing beyond April 2002, and hence would not expect any impact on investment incentives. Subsequently, Transco has raised Network Code Modification Proposal 0488 which, if implemented, would amend the capacity incentive structure and ensure Transco faces a financial incentive to minimise buy-back costs over a wide range of scenarios.

3.4 Value and Treatment of Buy-Back Fund

Five respondents believed that it would be extremely difficult to forecast with any accuracy the required fund over any auction period (CON AG SSE TOT UR2). However they were of the opinion that any forecasting should be carried out in a transparent manner. One respondent (BGT) argued that such forecasting could lead to the setting of a Transco buy-back price that would act as an artificial floor in the market. Only one respondent (PG) expressed an opinion with regard to the method of forecasting buy-back costs - it should be forward rather than backward looking.

Two respondents (BGT UR2) were of the view that there was no link between auction outcomes and buy-back requirements and that this meant other mechanisms such as adjustments to the NTS commodity and or all transportation charges would continue to be required. This continued reliance on what were felt to be discriminatory mechanisms was a major disadvantage of the proposal according to seven respondents (MOB AG CON SSE SHE TOT NE).

With regard to any excess or deficit left in the buy-back fund at the end of the period, one respondent (PG) thought this should be excluded from the calculation of “K” while another thought that any excess should be returned to MSEC holders (TOT).

Transco’s Response

Transco agrees that there does not appear to be a clear relationship between auction outcomes and buy-back requirements and that therefore the present adjustment mechanisms may continue to be important. Transco recognises that any approach necessarily has distributional effects.

Transco modelling suggests that buy-back requirements have a wide spread of possible outcomes which, combined with price volatility, mean that costs have the potential to show wide variation. Transco would endeavour to explain its process for forecasting buy-back costs. However, it does share concerns regarding the possible setting of artificial floor prices.

Transco is of the opinion that the unpredictability of buy-back costs means that any excess or deficit in the buy-back fund at the end of the period should not be included within the calculation of “K”. Transco believes that this excess or deficit would most appropriately be passed back to the community on the basis of MSEC holdings, given that this is the methodology used in the present incentive mechanism.

3.5 Effect of Network Code Modification Proposals 0481 and 0483.

Two respondents (UR1 BGT) expressed the opinion that the proposal would be unacceptable if Modification Proposal 0483 was to be implemented. The former thought that the combination would lead to higher auction prices and buy-back costs for shippers at both Barrow and Teeside. The latter was of the view that it would merely allow Transco to build up a larger buy-back fund so reducing its financial risk.

On the other hand, the implementation of a top down approach to sales of entry capacity, as envisaged by Modification Proposal 0481 was felt to provide the correct circumstances for the creation of a buy-back fund – a view expressed by two respondents (UR1 PG).

Transco’s Response

While Transco agrees that any top down approach to the provision of entry capacity increases the likelihood of buy-back, it would suggest that this does not fundamentally alter the case for or against the proposal under consideration.

3.6 Creation of an ESCROW Fund

Four respondents (AG MOB CON TOT) put this forward as an interim solution given the short timescales and outstanding questions surrounding the present proposal. One (AG) also felt that the creation of such a fund entirely broke the link between bidding behaviour in the auctions and any adjustment mechanism.

On the issue of the time required to change the Licence, one respondent (MOB) expressed the opinion that the August 2001 auctions could proceed on the basis of the proposal so long as Ofgem instigated the process of change on a “minded to proceed” basis.

Transco’s Response

Transco agrees with the view that this interim solution would require a Licence change, which Ofgem would need to initiate.

3.7 Other Issues

Three respondents wondered why an option rejected completely in PD13 should now be raised by Transco as a possible means of dealing with deviations from target revenue (BGT SSE NE).

Three respondents (BGT SSE CON) expressed the concern that the creation of a buy-back fund might result in gaming behaviour by Transco and shippers as well as affecting bidding behaviour in the auctions.

Two respondents (SSE AEP) wished to know whether the proposed new methodology was expected to last past March 2002 by which time the present form of regulatory control will end.

Transco’s Response

Transco rejected the creation of a buy-back fund in PD13 because of the probable need for an accompanying licence change and because of a desire to retain a shared stakeholder incentive to find appropriate outcomes to constraint management problems. Transco also notes that the context of PD13 was that of finding a suitable treatment of a considerable over recovery. Transco is of the view that if introduced the mechanism should be reviewed as part of the consideration of the arrangements required for the regulatory regime from April 2002.

Transco is not clear why implementation of this proposal would create a significantly different opportunity for gaming relative to any other approach, and believes that the Competition Act provides the necessary protections.

4. Conclusion

Despite the constraint of a limited consultation period, Transco welcomes the constructive and full comments received, which suggest that introduction of a mechanism whereby revenue from entry capacity auctions could be used to fund the costs of constraint management has both advantages and disadvantages.

Transco notes that the majority of respondents do not support implementation of the approach put forward in PC65. Transco shares a number of the concerns raised, and agrees that it would be preferable for the introduction of any form of buy-back fund to be supported by a modification to its PGT Licence. However, Transco also believes that responses demonstrate there is support for the concept of a buy-back fund, if not the precise approach set out in PC65. This suggests a modified approach may be appropriate rather than that set out in

PC65. In light of responses received, Transco believes in particular that, were a buy-back fund approach to be adopted, it would be appropriate for the size of any buy-back fund to be dependent on auction outcomes rather than based on an estimate of likely buy-back costs.

When developing its Transportation Charging Methodology, Transco needs to consider its PGT Licence Obligations. Transco believes that a buy-back fund should be considered on the basis of taking into account business developments given implementation of Network Code Modification Proposal 0481 – which has increased the expected scale of buy-back. Transco also has to consider the potential impact of changes on competition between shippers and between suppliers, and is conscious of the argument that competition is likely to be furthered by stability in the Charging Methodology.

In light of these issues and the views expressed, Transco proposes to retain the broad approach set out in PC65 but to base the size of the buy-back fund on any excess auction revenue. Hence Transco would not estimate potential buy-back costs in advance, and there would be no addition to the target level of revenue from the next round of auctions. However, excess revenue above the target level would be passed to Users in proportion to MSEC holdings rather than being used to reduce the NTS Commodity charge – which would be increased with effect from 1 October 2001 to 0.0136 pence per kWh. In addition Transco proposes that the aggregate level of the reduction in proportion to MSEC holdings should be constrained such that it does not exceed the level of shipper buy-back costs. Any excess over buy-back costs would be retained by Transco and dealt with through the usual mechanisms for keeping collected income within the level determined by the price control formula.

Transco therefore proposes, with effect from 1 October 2001, to replace the existing measures in its Transportation Charging Methodology for dealing with any excess auction revenue with the following steps:

- 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 User buy-back costs, the excess amount for the following month will be increased by the amount by which the excess exceeds aggregate User buy-back costs; and

- Transco will reduce each Users' entry capacity charges by a share of the lower of the excess or buy-back costs for the relevant month, with that share based on the proportion of aggregate MSEC held by the User concerned in the relevant month, subject to that share not exceeding its unadjusted entry charge.