

Direct Dial: 020-7901 7327

24 August 2001

Transco, Shippers and Other Interested Parties

Our Ref: PC66

Dear Colleague,

Pricing Consultation 66

Ofgem has decided not to veto Pricing Consultation (PC) 66, '*Transportation Charge Adjustments Following Entry Capacity Auctions*'. The reasons for this decision are set out in the accompanying paper.

Transco has submitted a report in respect of PC66 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 adjusts the existing revenue adjustment mechanism (established through PC60 , '*Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions*') that would apply in the event of an under-recovery of revenue (as against revenue allowed under Transco's price control) resulting from the forthcoming National Transmission System (NTS) entry capacity auctions, due to commence on 29 August 2001. Under the proposal any under-recovery would be made up through increases to general transportation charges, rather than being focussed solely on the National Transmission System Commodity charge.

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,

A handwritten signature in black ink, consisting of several overlapping, fluid strokes that form a cursive representation of the name 'Steve Smith'.

Steve Smith
Director, Trading Arrangements

Ofgem's views on Transco's Proposal to adjust transportation charges in the event of under-recovery of revenues following the August 2001 entry capacity auctions (PC66)

Introduction

Transco circulated PC66 for consultation on 13 August 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 4 days.

Transco has raised this Pricing Consultation following Ofgem's acceptance of Network Code Modification 0481 '*Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction*'. Modification 0481 provided for the release of Monthly System Entry Capacity (MSEC) quantities for each Aggregate System Entry Point (ASEP) for each month equivalent to the highest of the monthly ASEP Maximum System Entry Capacities published by Transco in its auction invitation letter on 29 June 2001. As a result, the quantity of MSEC being offered for sale in the forthcoming August 2001 auction will be higher than that offered in past auctions. Accordingly, Transco says that it is arguable that there is an increased probability of auction revenue being lower than that which would have been raised through administered entry charges, potentially resulting in an under-recovery of revenues against target.

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

Following Ofgem's July 2000 decision not to veto 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. This amount feeds into the 'K' adjustment factor, which is a general adjustment in all transportation charges.
- Where the deviation is greater than 10 per cent, National Transmission System (NTS) commodity charges are adjusted, subject to a minimum level (0.002 p/kwh).

- Any remainder results in a further 'K' factor adjustment.

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

The proposal

The pricing consultation proposal provides that, in the event of an under-recovery of revenues realised in the forthcoming August 2001 auctions of MSEC, the revenue adjustment mechanism (established through PC60) would be adjusted. The proposal provides that any shortfall of revenue would be recovered through an increase in general transportation charges rather than being focussed solely on increasing the NTS commodity rate.

Respondents' views

The majority of respondents were opposed to the proposed change to Transco's pricing methodology.

A number of respondents, including both respondents who supported the proposal and those who opposed it, expressed dissatisfaction with the shortened period of consultation. These respondents felt that the shortened consultation period did not allow sufficient time to fully consider the impacts of the proposal.

On a related issue, a number of respondents expressed disappointment with the number of changes being made and proposed to the current regime at this late stage prior to the next round of capacity auctions, when shippers were developing their bidding strategies. Other respondents were also concerned at the volatility and instability in transportation prices caused by such changes, which impaired the ability of shippers and suppliers to effectively compete, and of customers to manage their costs. They said that this was particularly acute when changes to prices were made at short notice and gas contracts were either finalised or in the process of being finalised.

A number of respondents compared the proposal with the current mechanism embodied in PC60. Some respondents that opposed the proposal indicated that it conflicts with the general principle underlying PC60 that adjustments to charges made as a result of over or under-recovery of entry capacity auctions should be ring-fenced to NTS charges. Similarly, several respondents suggested that the Transco proposal would result in an asymmetric treatment of under and over recoveries.

One respondent opposing the proposal suggested that an escrow account should be established for over and under recoveries to provide additional time for the industry to determine the most appropriate mechanism for dealing with revenue imbalances following entry capacity auctions.

Several respondents were in support of the proposal. One respondent supporting the proposal suggested that as general transportation charges were reduced following the previous auctions it is appropriate to spread the effect of any under recovery over all transportation charges. Another respondent viewed the proposal as allowing the adjustment mechanism to operate similarly in both directions. One respondent viewed this proposal as being an interim solution only and that the development of a longer-term solution should be made a high priority.

Ofgem's views and reasons for decision

Transco has submitted a report in respect of PC66 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 both Transco to ensure that, in future, proposed amendments to the Transco's pricing methodology are conducted in a timely manner well before the auctions are due to start.

Ofgem stated in its response to PC60 that in general we supported a methodology that is robust to dealing with any of the possible outcomes under the auctions relating to over or under-recovery of revenue and that revenue over and under-recovery should be dealt with in a consistent manner. Ofgem also stated its belief that, in general, it is preferable to deal with entry capacity revenue deviations through other NTS charges rather than affecting other transportation charges.

However, Transco's current charging methodology and formula revenue are set on the basis of a charging year. In the first six months of this year there was an over-recovery, as a result of the summer auctions, relative to Transco's target revenue for the first six months of the charging year. The size of the over-recovery was such that, under the current methodology, the general level of transportation charges were reduced for the remainder of the charging year to ensure that Transco did not over-recover over the whole charging year. In re-setting the general level of transportation charges Transco was implicitly assuming that there would not be a significant under-recovery in the winter auctions. Any under-recovery would necessitate an increase in transportation charges for the last six months of the year to ensure target revenue for the whole year was recovered.

In determining target revenues for six month periods within the year to determine whether or not there has been an under or over recovery, Transco is clearly implicitly taking a view on the appropriate profiling of revenue recovery within the charging year. In assessing whether or not there has been an over or under recovery over the year as a whole, it would be preferable to do so on the basis of actual auction revenues over the year as whole.

Ofgem considers that it is appropriate for any rebalancing of revenue arising from the six monthly NTS entry capacity auctions to be addressed in the context of the 1 April 2001 to 31 March 2002 gas year as a whole. In particular, under the current market based arrangements for the allocation of entry capacity, Ofgem does not believe that there should be a presumption that revenues are to be recovered in the first or last 6 months of the gas year. As such, Ofgem believes that this proposal is consistent with the principle of ensuring that Transco's revenues are recovered over a full year and is consistent with the principles the PC60 methodology.

If this revised methodology were not implemented and in the event of entry capacity clearing at reserve prices, NTS commodity charges would increase whilst other

transportation charges would continue to be lower than expected as a result of a 'notional' over-recovery over the first six months of the charging year.

Ofgem continues to support the general principle that transportation charges are adjusted as necessary to ensure that allowed revenues are recovered over the charging year. In particular any revenue rebalancing mechanism should seek to ensure that if (on the basis of reasonable expectation) it appears that there will be an over or under recovery over the charging year as whole, transportation charges are altered as necessary as soon as possible.

Accordingly, in the event that the forthcoming auctions result in an under-recovery, Ofgem considers that general transportation charges should be increased such that the reduction in LDZ charges from the last auctions is reversed to some extent, rather than being directed solely to the NTS commodity charge.

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.