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Direct Dial: 020-7901

28 September 2001

Transco, Shippers and Other Interested Parties

Our Ref: PC67

Dear Colleague,

### **Pricing Consultation 67**

#### *Authority's decision*

Pricing Consultation 67 seeks to make a technical amendment to the mechanism introduced by PC65, '*Alternative Method of Funding Entry Capacity Constraint Management*'. PC65 provides for revenue recoveries from the Transco Monthly System Entry Capacity (MSEC) auctions in excess of 10% of target revenue to be applied via a rebate to offset MSEC holders' exposure to the costs of capacity buy-backs. Any rebate paid to a shipper is based on the proportion of aggregate MSEC held by the shipper concerned in the relevant month. PC67 provides for the removal of a non-negativity condition contained in the pricing methodology established through PC65. This condition prevents any rebate that is paid to MSEC holders from being greater than the amount paid for entry capacity in the auctions.

Ofgem has decided not to veto Pricing Consultation (PC) 67, '*Technical Adjustment to PC65 Mechanism*'. The reasons for this decision are set out in the accompanying paper.

### *Effect of Ofgem's decision*

As a result of Ofgem's decision not to veto PC67, the buy-back fund established via PC65 and modified following PC67 will operate as follows:

Transco's over-recovery following the August 2001 capacity auctions of approximately £57 million will now be divided into 6 equal monthly amounts each of approximately £9.5 million.

Under the arrangements Transco will use each monthly amount to rebate transportation charges to MSEC holders in the event that Transco incurs buy-back costs.

If in any month the level of the buy-back fund exceeds MSEC holders' shares of buy-back costs under the Network Code, then MSEC holders' exposure to buy-back costs will be fully offset by the fund. Where the level of the buy-back fund exceeds MSEC holders' share of the total costs of buy-back then any over recovery that is not rebated will be rolled over into the next month's fund.

Conversely, if in any month MSEC holders' exposure to the costs of capacity buy-backs exceed the size of the fund then the remaining costs will continue to be charged back to shippers in proportion to their individual share of MSEC holdings.

Further, in the event that there are any revenues remaining in the buy-back fund at the end of the 6 month period then this revenue will be treated as general transportation revenue and will be rebated by adjusting the general level of transportation charges.

### *Summary*

In summary therefore as a result of Ofgem's decision not to veto PC67, the reduction in an MSEC holder's entry capacity charge applied to offset a shipper's exposure to its share of buy-back costs will no longer be subject to the condition that the rebate not be greater than the amount paid for entry capacity in the auctions. As such, the following words '*subject to that share not exceeding its unadjusted entry charge*' will now be removed from Transco's methodology statement.

I hope this explanation of the arrangements assists shippers and customers in understanding the impact of our decisions. Shippers and customers should read carefully the accompanying paper setting out the detailed reasons underlying Ofgem's decision to understand fully the effects of the changes to the arrangements, and should rely on the text of the pricing consultation rather than the above description in respect of their substance.

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, appearing to be 'Steve Smith', written in a cursive style.

Steve Smith  
**Director, Trading Arrangements**

## Ofgem's views on Transco's Proposal for a Technical Adjustment to PC65 Mechanism (PC67)

### **Introduction**

Transco circulated PC67 for consultation on 18 September 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 7 days.

### **Transco's proposal**

The pricing consultation seeks to amend the mechanism introduced by PC65, '*Alternative Method of Funding Entry Capacity Constraint Management*', such that the non-negativity condition contained in the pricing methodology is removed. Transco has indicated that this condition was originally included to ensure that payments were made, rather than received, to secure entry capacity.

Under PC65 where auction revenues exceed target revenues by more than ten per cent, then Transco will use any excess revenue to reduce MSEC holders' entry capacity charges in the event that buy-back costs are incurred. The mechanism by which this will occur is as follows:

- If auction implied revenue is above, but within ten percent of, the target level, there will be no automatic offsetting adjustment to transportation charges.
- If auction implied revenue is more than ten percent 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.
- Transco will reduce each MSEC holder's entry capacity charges by a share of the lower of the excess or User buy-back costs 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.

Under Transco's proposal, the reduction in an MSEC holder's entry capacity charge will no longer be subject to a condition that the rebate not be greater than the amount paid for entry capacity in the auctions.

### **Respondents' views**

A clear majority of respondents offered support for this proposal.

A number of the respondents supported the proposal on the basis that it provided additional clarification to PC65 and was consistent with shippers' understanding of the operation of PC65. Several respondents also agreed that the proposal represented a technical adjustment to the pricing methodology.

One respondent in support of the proposal stated that the rules which formed the basis of bidders' valuations of the products auctioned should be changed only in exceptional circumstances. This respondent however considered that the amendment was technical in nature and was required as the pricing methodology 'may have run counter to the way in which bidders believed the mechanism would operate'.

One respondent, whilst supporting the proposal, expressed surprise that Transco had not also introduced another change to PC65, by providing that the full buy-back fund would be used before charging MSEC holders additional monies. This issue was the subject of Network Code Modification Proposal 0494, '*Amendment to the Capacity Neutrality Arrangements*'. Ofgem is releasing its decision on this proposal today.

Another respondent, while supporting the proposal, expressed disappointment over the confusion about the practical application of the final proposals on PC65 and differences between Ofgem's explanatory decision letter of 24 August 2001 and Transco's report. This respondent called on Transco to clearly set out exactly how PC65 will work, including details of the 'excess amount' and how the adjustments will be made, eg, which invoices will carry them.

The respondent opposed to the proposal expressed concern that major changes had been made to the operation of the winter auctions without the industry fully understanding the implications of those changes. This respondent stated that the wording of pricing changes, which have significant material effects, should read like a contract, similar to Network Code legal text. In this respect, this respondent noted that terms used in PC65 are not defined making it difficult to interpret what has been proposed. It went on to say that PC67 did not resolve this problem, because there was no further explanation of the terms. It said that Ofgem's decision letter on changes made for the winter auctions was not clear about how PC65, Transco's new incentives and buy-back smearing would interact.

This respondent indicated that it expressed concerns to Transco about the effects of PC65 as the wording of the proposal meant that shippers would only receive their full share of the over-recovery if their share was equal to or less than the amount they paid for entry capacity as a result of their bids. This respondent expressed concerns about this aspect of PC65, because it could lead to different amounts being paid back to different shippers, ie those who paid more in the auctions getting refunded more from the buy-back fund. However, the respondent indicated that it did not support the proposal, as it was inappropriate to change the rules of the capacity regime after the auctions had been completed.

Finally, this respondent indicated its opposition to the proposal on the basis that it did not address any of the problems or uncertainties created by the implementation of PC65. In particular, it drew attention to what would happen to the excess left over at the end of the auction period and the timing of adjustments to transportation tariffs.

### **Transco's views**

In its consultation report on PC67 Transco has indicated that, although ex-post changes to the pricing methodology are undesirable, the removal of the non-negativity condition represents a technical amendment that will better meet the intent of PC65. In this respect Transco has indicated that possible differing interpretations of this aspect of the pricing methodology are unlikely to have had any major effect on bidding behaviour in the most recent series of MSEC auctions.

### **Ofgem's views and the Authority's decision**

Transco has now submitted its consultation report in respect of PC67 to Ofgem. The Authority has decided not to veto this proposal.

In reaching this decision, Ofgem has given careful consideration to the views put forward by all respondents during the consultation process.

Ofgem notes the concerns raised by some respondents regarding uncertainties relating to the operation of the PC65 mechanism. In this respect Ofgem would urge shippers with these concerns to seek any further clarification regarding the operation of the buy-back fund mechanism from Transco. Indeed Ofgem agrees with respondents that it would be helpful if Transco provided more information to shippers on the practical operation of PC65, for example through the use of practical examples. However, this concern should not impact on the matters addressed in PC67.

Ofgem also notes the concerns raised by one respondent regarding the wording of amendments to Transco's pricing methodology. Ofgem shares these concerns and would also urge Transco to ensure that pricing consultations are sufficiently detailed with appropriate definitions of relevant terms.

Ofgem accepts that the change is technical in nature and that the removal of the non-negativity condition better meets the intent of PC65.

Ofgem set out the intent of PC65 in our letter of 24 August 2001, which explained the effect of our decisions in relation to the winter 2001 entry capacity auctions. In this letter Ofgem stated that '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.' In this respect Ofgem considers that the non-negativity constraint is inappropriate as it prevents Transco from giving full effect to the policy intent of PC 65.

Ofgem is also mindful that several respondents agreed that this proposal represents a technical amendment to the pricing methodology.

Ofgem acknowledges that retrospective changes to the rules under which shippers participated in the auctions should be avoided, except in exceptional circumstances. However in this instance Ofgem shares the views of Transco and the majority of participants that the change to the methodology proposed through PC67 is of a

technical and non-material nature and intended to ensure that the methodology statement more accurately reflects the intention behind PC65. Having carefully considered the benefits of PC67 in the light of its limited retrospective effect, Ofgem has considered that it is appropriate to approve its implementation.