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18 January 2002

Transco, Shippers and Other Interested Parties

Our Ref: PC70

Dear Colleague,

Pricing Consultation 70

Ofgem has decided not to veto Pricing Consultation (PC) 70, '*NTS System Operation Transportation Charges*.' The reasons for this decision are set out in the accompanying paper.

This proposal replaces the current National Transmission System (NTS) standard commodity charge with a System Operator (SO) commodity charge based on target SO revenue. The SO commodity charge will apply to gas transported through the NTS, on the basis of offtakes from the NTS, irrespective of the type of end load. A particular effect of this will be that the SO commodity charge will be payable on gas transported to storage sites.

The SO commodity charge will take effect from 1 April 2002 and will be based solely on exit flows. It will not initially apply to entry flows. Transco has agreed with Ofgem to bring forward a further pricing consultation in order to seek views on levying the charge on both entry and exit flows from 1 October 2002 as envisaged by Ofgem's Final proposals for Transco's SO incentives. Ofgem also understands from Transco that a Network Code modification will also need to be raised to enable Transco to levy the SO commodity charge on entry flows.

The SO commodity charge will recover allowed SO revenue, including system balancing costs, NTS SO internal costs and the revenues or payments arising from the NTS SO incentive schemes.

Ofgem also considers that the costs associated with the current neutrality charges (eg gas balancing) and the net costs associated with capacity management should be recovered through the SO commodity charge. In this respect, Ofgem intends to propose amendments to Transco's Gas Transporter's licence that will enable Transco to recover these costs from 1 April 2002. These proposed licence modifications will be brought forward in February 2002 as part of a broader package of licence modifications intended to introduce Transco's System Operator incentive proposals. If the licence modification proposals are accepted then consideration will need to be given to the impact of these changes on the existing energy and capacity neutrality mechanisms and whether or not these mechanisms should be removed.

Ofgem also notes that it has not elected to veto Transco's proposal to continue the NTS Optional Commodity tariff in its present form.

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,

Nick Fincham
Director, Gas Trading Arrangements

Ofgem's views on Transco's Proposal for NTS System Operation Transportation Charges (PC70)

Background

Under Ofgem's final proposals for Transco's Transmission Asset Owner (TO) price control[1] and National Transmission System (NTS) System Operator (SO) incentives[2], Ofgem has proposed separating the regulation of Transco's role as NTS TO, where it builds and maintains the network, from Transco's role as NTS SO, where it determines the need for additional NTS capacity and the day-to-day operation of the system. As part of the price control review, Ofgem has also introduced separate price controls for the NTS and the Local Distribution Zones. These proposals, subject to confirmation of Transco's acceptance, will take effect from 1 April 2002.

Under Ofgem's final SO incentives proposals, the SO will be subject to a number of incentives designed to improve significantly the long-term signals and the incentives for timely investment in the NTS by Transco, in response to its customers' changing needs. The incentives are also designed to improve the efficiency of Transco's day-to-day operation of the NTS.

Transco's proposal

Transco has proposed to replace the existing NTS standard commodity charge with a SO commodity charge. The proposed SO commodity charge would:

- be levied on all gas transported on the NTS, based on exit flows (the proposed charge will not be levied on entry flows);
- be adjusted to address the payments or revenues arising from the SO incentive schemes; and
- recover Transco system balancing and SO internal costs.

This proposal does not affect the current neutrality arrangements, which apply to residual gas balancing, operating margins (gas) and capacity buy-backs. In particular, the proposal assumes that neutrality arrangements for recovering the net costs of these will continue.

Transco has proposed that the charge be applied to all NTS throughput irrespective of the type of load. The charge will therefore be applied to gas transported to storage sites.

Transco has also proposed a continuation of the Optional commodity tariff in its present form.

Respondents' views

General principle

A clear majority of respondents offered general support for the principle of replacing the existing commodity charge with a SO commodity charge. Respondents noted that to ensure

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[1] *Review of Transco's Price Control from 2002 Final proposals*, Ofgem, September 2001.
[2] *Transco's National Transmission System system operator incentives 2002-7 Final proposals*, Ofgem, December 2001.

consistency with the new price control arrangements, the SO charge should be based on target SO revenue, rather than being based on a given proportion of NTS target revenue. However, a number of respondents expressed reservations in their ability to comment on the proposal, given Ofgem's final SO incentive proposals were yet to be finalised. In this respect, two respondents suggested that further consultation should be held once the regime was clearer.

Scope and volatility of the charge

A number of respondents expressed concern regarding the frequency and volatility of adjustments in the proposed charge. They argued that since the commodity charge will be used as a balancing charge and for funding incentive revenue, it will change when target revenues change. In this respect, a number of shippers suggested that Transco should ensure the frequency of adjustment should be limited to provide stability. One shipper suggested that adjustments to the SO charge should be made on an annual basis as a maximum, whilst another argued that the full two months notification period should be followed for changes to the charge, in order to provide stability for suppliers and customers.

A number of respondents requested further clarification of what charges were included within target revenue, with one shipper questioning what assumptions Transco will make in respect of its performance under the incentive schemes. Another shipper noted that it would be helpful if Transco made an estimate of the likely range over which the charge could vary.

Application of the charge

Three respondents specifically commented on the proposal to levy the charge based solely on exit flows and several questioned why the charge would not also be based on entry flows. One argued that the utilisation of network assets and hence the cost drivers appeared to be the same for entry and exit. It therefore argued that a charge based on both entry and exit flows would be more cost reflective. Other respondents also argued that a charge based solely on exit flows would be advantageous to traders at the National Balancing Point (NBP) and suggested a 50:50 split, consistent with equivalent electricity charges levied by the National Grid Company.

A number of respondents offered support for the retention of the neutrality arrangements for capacity buy-backs, residual gas balancing and operating margins gas costs. One of these respondents argued that neutrality should be retained because it is based around established processes and principles. However, another respondent expressed concern that some costs would be recovered through neutrality, while other costs would be recovered through separate processes, resulting in a lack of clarity in understanding the total costs of system operation. This respondent nevertheless said that the proposed arrangements may be appropriate in the short term.

Of those shippers who specifically commented on the proposal to levy the charge on gas flows into storage, the majority offered support for the proposal. These respondents suggested that this was more cost reflective and a number argued that this would remove the current discrimination between different types of system users. However, a number of respondents requested further discussion and sought clarification of the impact of levying the charge on storage gas flows.

One respondent, opposed to levying the charge on storage gas flows, argued that the proposal would lead to increased storage and flexibility costs and might reduce liquidity at the NBP. Another respondent expressed concern that applying the charge to only certain storage sites could be discriminatory, would undermine the value of storage and may be a disincentive to the development of the independent gas storage market. A number of respondents also noted that a shipper could face large charges for flows into and from storage sites, even if their net position was zero.

Optional commodity tariff

The majority of respondents who commented on the proposal to retain the optional commodity tariff offered some support for the proposal. In general, respondents argued that the tariff should remain to avoid the possibility of uneconomical bypass. One shipper argued that the optional commodity tariff should remain until further consideration is given to the development of the SO commodity charge. Other respondents noted that that since system bypass is more relevant to the TO than the SO it may be more appropriate to deal with this via TO charges. However, it recognised that this may be difficult because of the entry capacity auctions.

A number of shippers, whilst accepting that some elements of the SO charge might be more cost reflective if charged on a distance basis, argued that some elements are not distance related and arise from an integrated transportation system. They therefore argued that it would be appropriate to retain a standard charge and continue with some form of optional tariff to suppress incentives for system bypass. One shipper thought that the issue of whether the SO commodity charge should be distance-related was an issue of cost-reflectivity versus simplicity. This respondent said that a commodity charge based on both entry and exit flows could be a compromise.

Transco's view

In its final report on PC70, Transco noted that it had taken Ofgem's final SO incentive proposals into account in its final proposals for changes to the charging methodology and invited the industry to provide any further comments it had in light of the final SO incentive proposals.

Scope and volatility of the charge

In its final report Transco stated that it hoped that the SO commodity charge would be relatively stable over time, but noted that there is considerable uncertainty about the operation of the revised price control arrangements and the implications for price stability. Transco expressed the view that the level of the charge is likely to be affected by performance under the incentive regime as well as the scope of the neutrality arrangements. Transco also noted that the indicative SO commodity charge in PC70 is based on an assumption of neutral performance within any incentive scheme.

Application of the charge

Transco noted that in a competitive gas supply market, gas prices at the NBP would be expected to take into account transportation costs incurred and therefore disputed the suggestion that charging on the basis of exit flows would lead to distortions along the gas supply chain. However, while Transco accepted that charging on the basis of entry and exit may be appropriate, it believed that the additional costs and complexity involved outweighed any benefits in the short term. These costs related to systems and invoicing.

Transco has since agreed with Ofgem to bring forward a further pricing consultation in order to seek views on basing the charge on both entry and exit flows from 1 October 2002 so as to allow for the necessary systems and invoicing changes to be effected.

Transco argued that because there is typically no difference in transportation costs incurred between transportation to storage exit points and transportation to other similar supply points, the SO commodity charge should apply to all NTS flows, including flows to storage sites. However, because this change to the charging of storage flows would require a change to the Network Code, Transco will raise a Network Code modification proposal to seek views on implementing the charge in relation to storage. The modification process will allow for further debate on the application of the SO commodity charge to storage flows.

Optional commodity tariff

While Transco recognised that the continuation of the optional commodity tariff in its present form may not be an ideal method of dealing with the issue, it believed that it is a pragmatic method of helping to avoid uneconomic bypass.

Ofgem's view

As noted in our final SO proposals, Ofgem broadly supports the principle of introducing a single, throughput-based charge for recovering the costs associated with the SO incentive regime. In this respect, we welcome Transco bringing forward this pricing consultation.

In our December document, Ofgem outlined a number of concerns regarding Transco's initial PC 70 proposals. In particular, we suggested that it might be more appropriate if the SO commodity charge was levied on gas flows at both entry to and exit from the NTS, covered the costs associated with the current neutrality charges and also covered the net costs associated with capacity management. Ofgem recognised, however, that inclusion of this final component into the SO commodity charge could introduce considerable volatility into the charge if target and actual buy-back costs are considerably different.

Application of the charge

Ofgem continues to believe that it is appropriate to levy the SO commodity charge on both entry flows and exit flows. This is because the costs borne by the SO can either be caused by the patterns of gas entering or exiting the system. Accordingly, splitting the charge between entry and exit would allow for better cost targeting.

Transco has however indicated that, because currently there is no entry-based throughput charge, it would need to undertake additional systems and invoicing development to implement the SO commodity charge at entry. In particular, Ofgem understands that the introduction of such a charge would take up to six months and would require a Network Code modification and a further pricing consultation to clarify the charging basis. Transco has indicated to Ofgem that it is intending to bring forward the necessary Network Code modification and pricing consultations to seek views on the levying of the commodity charge on entry with effect from 1 October 2002.

Ofgem also continues to believe that the SO commodity charge should be used to recover the costs associated with the existing neutrality charge (eg gas balancing) and the net costs associated with capacity management. In relation to shippers' exposure to buy-back costs, we believe that recovering these costs through the SO commodity charge rather than on capacity holdings will reduce the likelihood of distorting shippers' bidding behaviour in the entry capacity auctions and allow for better signals to emerge from the long-term auctions. In this respect, Ofgem will shortly be issuing a Gas Act section 23 notice proposing modifications to Transco's Gas Transporter's Licence, which will seek to implement Transco's SO incentives. These licence modification proposals will, if implemented, effectively enable Transco to recover the costs associated with the current neutrality charges (eg gas balancing) and the net costs associated with capacity management through the SO commodity charge from 1 April 2001.

Ofgem agrees in principle that the SO commodity charge should apply to all NTS flows including the flows into storage sites. Ofgem recognises that some respondents have raised concerns regarding the methodology to be applied in levying and allocating charges associated with gas flows into storage. Ofgem however understands that Transco will shortly be raising a Network Code modification to consult upon and determine the basis on which the SO commodity charge will be applied to flows into storage sites. In the absence of any such Network Code modification, exit flows into storage facilities cannot attract the SO commodity charge.

Ofgem also notes that in certain circumstances storage facilities may provide services that should assist Transco in efficiently and economically balancing its system. In particular, storage facilities may be able to provide national and locational gas services to Transco within short delivery times with system balancing benefits. In this respect, Ofgem considers that its proposals for Transco's SO incentives should provide Transco with incentives to purchase services of this nature where it is efficient to do so thereby rewarding the providers of these services. Indeed, Transco is already able to contract for the provision of short-term locational gas through the On-the-day-commodity market.

Ofgem does not therefore believe shippers flowing gas into storage should be treated differently to other users of the NTS in bearing a proportion of the costs associated with the operation of the NTS based on throughput. To the extent that these shippers provide any benefits to the system, these benefits should be reflected in any contracts entered into with Transco for the provision of system balancing services.

Optional commodity tariff

Whilst Ofgem has not elected to veto the continuation of an optional commodity charge, Ofgem believes that Transco should review as a matter of urgency the extent to which the charging methodology gives rise to an Optional Commodity rate that reflects the costs incurred by the licensee in its transportation business within the terms of its Gas Transporter's licence (Standard Condition 4A).