Direct Dial: 020-7901 7437

30 July 2002

Transco, Shippers and Other Interested Parties

Our Ref: PC73

Dear Colleague,

Pricing Consultation 73

Ofgem has decided not to veto Pricing Consultation (PC) 73, *'Structure of the NTS SO Commodity Charge'*. The reasons for this decision are set out in the accompanying paper.

This proposal provides for the SO commodity charge to be levied on gas entering the gas transportation system at system entry points, as well as gas offtaken at exit points from the NTS.

The proposal does not change the target level of revenue to be recovered through the NTS SO commodity charge, but applies the same level of charge to entry and exit such that roughly 50 per cent of the revenue collected is obtained from entry and exit respectively.

This change to the charging methodology will take effect from 1 October 2003.

If you have any questions on this letter, or the accompanying paper, please do not hesitate to contact me on the number above, or Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements

<u>Ofgem's views on Transco's Proposal for Structure of the NTS SO Commodity Charge (PC73)</u>

Background

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 in December 2001[1] and published licence modifications for statutory consultation under section 23 of the Gas Act 1986 in April 2002 together with an explanatory note on 12 April 2002.[2] These proposed modifications seek to introduce into Transco's Gas Transporter (GT) licence, with effect from 1 April 2002, new price controls and SO incentives for Transco. The modifications also seek to separate the regulation of Transco's role as Transmission asset Owner (TO) where it builds and maintains the network from its role as NTS SO where it determines the need for additional capacity and the day-to-day operation of the system. Ofgem is currently considering the responses that it has received to its consultation on the GT licence modification proposals.

On 18 January 2002, Ofgem decided not to veto Pricing Consultation (PC) 70, *'NTS System Operation Transportation Charges'*. PC 70 replaced the National Transmission System (NTS) standard commodity charge with a SO commodity charge, which has applied since 1 April 2002. The SO commodity charge is levied on all gas transported on the NTS, based on exit flows. It recovers Transco's system balancing costs, SO internal costs and is adjusted to address payments or revenues arising from Transco's proposed SO incentive schemes. PC 70 also provided that the SO commodity charge should be applied to NTS flows into gas storage sites. The basis on which the SO commodity charge is to apply to gas storage sites is currently the subject of a number of Network Code modification proposals. In the absence of a Network Code modification, flows of gas into storage cannot attract the SO commodity charge.[3]

The views expressed in this letter do not in anyway fetter the discretion of the Authority with respect to the proposed licence modifications referred to above.

Transco's initial proposal

This proposal provides for the SO commodity charge to be levied on gas entering the gas transportation system at system entry points, as well as gas offtaken at exit points from the NTS. This would not change the target level of revenue to be recovered through the NTS SO commodity charge, but applies the same level of charge to entry and exit such that roughly 50 per cent of the revenue collected is obtained from entry and exit respectively. The unit commodity charge applicable would be roughly half that which would otherwise apply on an exit-only basis.

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[1] *'Transco's National Transmission System Operator Incentives – Final proposals'*, Ofgem, December 2001.

[2] *'Transco price control and NTS SO incentives 2002-7, 'Explanatory Notes to accompany the section 23 notice of proposed licence modifications to Transco's gas transporter licence'*, Ofgem, April 2002.

[3] Modification Proposal 0532, *'Application of SO Commodity Charges to all NTS Loads'*; Modification Proposal 0545, *'Application of SO Commodity Charges to Storage Facilities'*; Modification Proposal 0546, *'Application of SO Commodity Charges to Storage* Facilities'; and Modification Proposal 0547, *'Reconciled SO Commodity Charges at Storage Facilities'*.

Transco originally envisaged that this change to the charging structure would be introduced from October 2002.

Respondents' views

Respondents were fairly evenly divided in terms of support for the proposal, with a number of those supporting the proposal qualifying their support.

Justification for the proposal and cost reflectivity

Several respondents agreed that the proposal would lead to a more cost-reflective charging structure and expected that the change would have a close to neutral effect on the gas price. A number of respondents agreed that shippers who offtake gas from the NTS are not the only physical users who contribute to the costs of running the NTS and as such should not solely be required to pay for these costs which can also be attributed to other areas of the NTS.

However, while one respondent thought that the proposal appeared to be more cost-reflective, it considered that there was a possibility that some shippers and hence customers would be picking up both a price increase at the NBP and a cost pass through of the charges.

A number of respondents considered that there was little justification for the proposed change. Respondents raised issues including that it would add unnecessary complexity to the charging regime and add to existing uncertainty associated with other changes currently occurring within the industry, without changing the level of Transco's cost recovery.

Some respondents, whilst supportive of the principle stated that there is uncertainty associated with the components that make up the SO commodity charge. In this context, one respondent sought clarity on the charging treatment of buy-back costs. Another sought clarity on whether separate neutrality arrangements would be introduced rather than a single bundled SO commodity charge.

One respondent, while not against the principles underlying the consultation, wanted to see evidence of how the proposal would better reflect Transco's costs. Another respondent suggested that recovery costs across all entry and exit points does not go far enough in targeting costs. Each of these respondents commented that Transco should give particular attention towards assessing the extent to which storage can mitigate system operation costs.

A number of respondents raised concerns regarding the potential volatility of the SO commodity charge. One respondent indicated that the charge should not be changed too frequently so as to avoid situations where the charge fluctuates within the pricing year. One respondent stated that the proposal would create uncertainty particularly at times when Transco may need to change the charge. The respondent stated that this uncertainty would reduce trading.

One respondent stated that there is a precedent for charging at both entry and exit in the electricity industry, where both generators and customers share the cost of transmission losses. However, it stated that it would welcome a further pricing consultation recommending a revised capacity/commodity split for the LDZs in order to better reflect the costs incurred.

However, a number of respondents questioned whether the proposal would better reflect Transco's costs. Two respondents made reference to the 'notional centre' of the NTS, with one arguing that gas flowing through the St Fergus entry terminal rarely if ever reaches this notional centre and another arguing that producers landing gas from the Southern Gas Basin are causing Transco to incur relatively little cost and yet pay the same charges as producers landing gas in the north.

One respondent recollected from original Network Code discussions that most of the costs occur at NTS offtake and metering points, which it argued justified the current charging structure, while other incentives targeted costs at entry.

Impact on the upstream industry and trading at the NBP

A number of respondents considered that the proposal would impact heavily on the upstream industry, including those producer-shippers that are currently delivering gas to the NBP only and on offshore producers that sell gas at the beach. Some respondents did not accept that NBP prices would adjust to reflect the extra commodity charge.

A number of respondents believed that the proposal would feed in to higher consumer prices, with one respondent doubting that companies taking delivery at the NBP would pass on the reduced commodity charge paid at exit to their customers. Some respondents believed that the charge would distort or have a negative effect on the NBP market.

A number of respondents felt that the proposal would adversely affect trading at the NBP. One respondent argued that producers would be pushed back to trading at the beach in order to avoid the SO commodity charge.

One respondent stated that Transco is potentially going to be involved in trading through forwards and options and considers that this position of influence is unacceptable, as Transco will determine the frequency and notice period of changes in charges. It felt that this would reduce liquidity at the NBP because it did not accept that the charge would immediately be incorporated within the NBP price.

Impact on existing contracts

Concerns were expressed by a number of respondents about the impact of the proposal on shippers with existing contracts, such as NBP contracts or end user gas plus transportation pass through contracts. Respondents argued that shippers will have entered into such contracts on the basis of the current structure of transportation charges and the structural alteration proposed changes the balance of risk experienced by both parties.

One shipper considered that this proposal would encourage shippers to not enter into fixed term agreements for gas, because this proposal would create windfall gainers and losers depending on shippers' relative positions and the short timescales between any decision being made and its proposed implementation date. This respondent also said that the change contributes to uncertainty about the structure of prices for shipping and trading gas which in the longer term is likely to produce upwards pressure on prices.

Respondents suggested different periods of notice as sufficient to allow for the renegotiation of existing contracts, ranging from implementation from 1 April 2003, to several years hence.

Application of SO commodity charge to storage flows

A number of respondents raised the issue of the application of the SO commodity charge to storage flows, making reference to the current network code modification proposals.

While supporting the proposal in principle, one respondent considered that it would be inefficient to implement a methodology to implement PC 70 in relation to storage flows in advance of a further change to implement PC 73. It supported a 'one-stage solution'. In addition, it considered that there is little possibility that Transco could introduce the 'PC 70 changes' in relation to storage flows before the desired implementation date of the 'PC 73 changes'.

Other respondents proposed that the process in respect of the network code modifications be completed before further debates on this issue are instigated and therefore opposed implementation of this element of PC 73 at this time.

However, a number of respondents considered that a decision on this consultation needs to be made before a considered opinion on the outstanding modifications can be made.

Some respondents argued that storage should be dealt with separately from other gas flows in terms of charging to reflect the benefits that storage sites bring to the system.

Notice period for price changes

A number of respondents expressed concerns relating to the notice period for changes to the SO commodity charge and stressed the importance of upholding the notice period for future changes to the commodity charge, to assist users to plan their businesses efficiently.

Systems changes

One respondent stated its assumption that a Network Code modification proposal would be required to implement this proposal and sought clarification that amendments to Transco's billing systems would be made in time for an October 2002 implementation date. Another respondent agreed with the suggested implementation date of October 2002 and urged Transco to keep to this date if the proposal is implemented 'so as not to conflict with their revenue flows under the new SO incentive schemes'.

Another respondent emphasised the impact on shippers' systems as well as the impacts for Transco's systems.

Other issues

Some respondents queried how sites currently eligible for the optional commodity tariff would be treated under this proposal.

One respondent expressed concern that the proposal would be contrary to Ofgem's desire to separate cost redistribution from primary bidding activity by incorporating elements of the operation of the entry capacity regime.

One respondent anticipated that further Network Code modification proposals are necessary to enable full implementation of this proposal and that these need to be taken forward together as soon as possible for October implementation. This respondent considered that this would not introduce significantly more complexity, nor would this necessarily lead to the development of a full zonal commodity regime.

Transco's view and amended proposal

Transco argued in its original PC 73 paper that, while allocating throughput-related costs to particular parts of its network or to particular activities is necessarily arbitrary, levying the charge on both entry and exit flows could be regarded as better reflecting the costs incurred and would ensure all shippers using the NTS would contribute directly to the revenue raised through commodity charges.

It argued that it would be expected that the costs of transporting gas from the NBP to the supply point would currently be taken into account in NBP trades, so that if the price of transporting gas from the NBP decreases and the price of transporting gas to the NBP increases by the same amount, then it would be expected that this would be reflected in the typical price of gas traded at the NBP. It thus argued that the proposed change to the charging structure is only likely to change the effective contribution of each shipper to total SO revenue to the extent that NBP prices do not fully adjust following any change in charging point.

Transco added that, whilst the drivers behind its SO costs and incentive adjustments are complex, some of them, for example the capacity buy-back incentive adjustment and the use of compressor fuel, are related to entry requirements. It argued that charging on both entry and exit flows would mean that the SO costs are reflected in the level of transportation charges for all shippers. It stated that the proposal would not increase the total level of charges incurred in transporting gas to end users and, because it expected the NBP price to adjust to take into account the change, did not accept that there would be a negative impact on NBP gas trading.

However, Transco recognised that, where there are longer-term contracts for gas trades at the NBP, the change could have a negative impact on some shippers in the short term. It therefore proposed that the change should not be implemented until October 2003 so that, where necessary, contracts can be revisited prior to implementation.

Transco added that this later implementation date would allow time for the application of the charge at storage entry points to be resolved. It also believes that the change in implementation date should help to resolve any implementation resource constraints.

Transco has indicated that the implementation of the change may require modifications to the Network Code and to billing systems.

Ofgem's view

As stated in Ofgem's decision letter on PC 70, we believe that applying the SO commodity charge on both entry flows and exit flows would allow for better cost targeting because the costs Transco incurs as SO in operating the NTS can be caused either by the patterns of gas entering or exiting the system. For these reasons and, in particular, when compared with the existing exit based SO commodity charge, we believe that an SO commodity charge that is applied to both entry and exit flows is more cost reflective.

Ofgem also considers that an entry/exit based approach is consistent with the arrangements in electricity, whereby the Balancing Services Use of System charge is recovered from both electricity users and generators on the basis of electricity flows into and out of NGC's transmission system.

Ofgem recognises that this change may have implications for shippers with existing contracts and is content with Transco's decision to delay the implementation of this pricing methodology change until October 2003. We note that, with the introduction of the New Electricity Trading Arrangements, most contracts between generators and suppliers were renegotiated to reflect, inter alia, the redistribution of NGC's charges between generators and suppliers.

Ofgem also recognises that this change to Transco's pricing methodology has implications for the application of the SO commodity charge to storage flows and will take these into account in considering the Network Code modification proposals which have been raised to apply the SO commodity charge to storage flows.