Shippers, Transco and other interested parties

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Dear Colleague,

Pricing Consultation Paper PC 75 - NTS TO Commodity Charge

Transco raised Pricing Consultation (PC) 75 *'NTS TO Commodity Charge'* for consultation on 22 July 2002 and submitted its report to Ofgem on 19 September 2002. Ofgem has decided to veto this proposal because we do not believe that the proposal better facilitates the relevant objectives of Transco's charging methodology, as set out in amended standard condition 4A of Transco's Gas Transporters (GT) licence. The reasons for this decision are set out in the accompanying paper.

The effect of vetoing this proposal is that the current mechanisms for rebalancing any under or over recovery of revenues against that allowed under Transco's National Transmission System (NTS) Transmission Asset Owner (TO) price control remain in place. In respect of future over recoveries, the mechanism established under PC 65, '*Alternative Method of Funding Entry Capacity Constraint Management*', as adjusted by PC 67, *'Technical Adjustment to PC65 Mechanism'*, will continue to operate. PC 66, '*Transportation Charge Adjustments Following Entry Capacity Auctions*', will continue to provide the mechanism in the event of an under recovery.

In raising this consultation, Transco proposed to introduce a TO commodity charge to allow for the redistribution of over or under recoveries of TO revenues, to operate alongside the mechanism established under PC 65. The proposed charge was to have had a structure identical to the current NTS System Operator (SO) commodity charge.

Respondents to this proposal have expressed concern about the lack of transparency and certainty in how the proposed charge would be set and adjusted. In this context, respondents raised concerns that the charge may become volatile. Whilst Ofgem is not opposed to the broad principle underlying this proposal, Ofgem recognises the concerns expressed by many respondents and considers that the proposal does not better facilitate the relevant methodology objectives, particularly relating to facilitating effective competition between gas shippers and between gas suppliers.

Ofgem agrees with the principle underlying the proposal and considers it necessary for there to be a rebalancing mechanism in Transco’s charging methodology to deal with revenue over and under recoveries of TO revenues. Ofgem would therefore welcome a further consultation on an appropriate TO revenue redistribution mechanism, which addresses the strong concerns expressed by respondents regarding charging certainty.

In addition, Transco could give consideration to proposals that would provide for a TO commodity charge (and, for that matter, all other transportation charges) to be revised once a year only with sufficient notice being given to shippers of this change. We would be interested in shippers’ views on this.

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

Ofgem's views on Transco's proposal for the introduction of the NTS TO commodity charge (PC 75)

Background

Ofgem published its modifications to Transco's Gas Transporters (GT) licence for 2002-2007 on 27 September 2002[1]. The modifications introduced Transco's National Transmission System (NTS) System Operator (SO) incentives and its Transmission Asset Owner (TO) price control, with effect from 1 April 2002. These modifications separate the regulation of Transco's role as TO, whereby it builds and maintains the NTS, from its role as NTS SO, whereby Transco determines the need for additional capacity and the day-to-day operation of the system.

Under Special Condition 28B of its GT licence, Transco is obligated to use its best endeavours in setting charges to ensure that in respect of any formula year the revenue which it derives from its NTS TO activity shall not exceed the maximum TO revenue set under its licence.

The current arrangements for rebalancing any over or under recovery of TO revenues are set out in PC 65, *'Alternative Method of Funding Entry Capacity Constraint Management'*, as amended by PC 67, *'Technical Adjustment to PC65 Mechanism'*, and PC 66, '*Transportation Charge Adjustments Following Entry Capacity Auctions'*.

In the event of an over-recovery, PC65 established a methodology whereby Transco rebates excess revenue by offsetting shippers' exposures to the costs of buy-backs (the buy-back fund). The buy-back fund is utilised when auction revenue exceeds target revenue by 10 per cent or more. This excess revenue is divided into six equal monthly amounts, and where the buy-back fund exceeds aggregate shipper buy-back costs in a particular month, the excess amount is carried forward to the next month. Any remaining over-recovery after the end of the first half of a formula year is carried forward into the buy-back fund for the second half of the year.[2]

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[1] Transco Price Control and NTS SO incentives 2002-2007 Licence modifications, Ofgem September 2002.

[2] PC 67, introduced in September 2001, made a technical amendment to the mechanism introduced by PC 65, by removing the non-negativity condition, such that, in the event of an over

PC 66 provides for adjustments to the general level of transportation charges in the event of an under recovery.

While not part of the consultation, in its report, Transco informed shippers that, with effect from 1 October 2002, the basis on which shippers' buy-back exposures are rebated under the buy-back fund mechanism will be amended to be consistent with recent changes made to the buy-back arrangements for distributing the costs of buy-backs to shippers.[3]

Transco's initial proposal

Transco proposed a change to the current charging methodology through the introduction of an NTS TO commodity charge. Transco proposed that if the TO revenue obtained from other charges were in line with TO target levels under its price control, then the proposed NTS TO commodity charge would be zero. If the TO revenue was out of line with TO price control target levels, due to entry capacity auction revenue levels or other factors, then the NTS TO commodity charge could be adjusted downwards (so as to be negative) or upwards.

Transco envisaged that the maximum negative NTS TO commodity charge combined with the NTS SO commodity charge would not be lower than the short-run marginal cost of operating the NTS.

Transco initially proposed that this methodology could either supersede or exist alongside the PC 65 buy-back fund provisions.

Respondents' views

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recovery, the reduction in an MSEC holder's entry capacity charge will no longer be subject to the rebate not being greater than the amount paid for entry capacity in the auctions.

[3] Ofgem accepted network code modification proposal 559, *'Changes to Buy Back Liabilities'* on 5 August 2002, which provided for buy-back costs to be smeared back to shippers on the basis of end-of-day firm capacity holdings.

There were sixteen responses to this pricing consultation. The majority of respondents were against the proposal, while a small number of respondents provided qualified support for the proposal.

Process issues and clarity of the pricing consultation paper

The vast majority of respondents objected to the introduction of the charge because the issue had not been discussed with the industry and they considered that Transco's initial pricing consultation paper was unclear. Several respondents were concerned about the number of piecemeal changes to Transco's charging methodology and one respondent considered that the consultation paper had been raised too close to the forthcoming auctions on an issue that required both careful consideration and discussion.

Mechanics of setting the charge and volatility in charges

There were a large number of requests for more details of how and when the charge would be applied, so that shippers could manage their risks. Several respondents considered that the proposal would lead to unknown volatility in charges, which would affect end user prices.

One respondent suggested that Transco's pricing discussions and consultations should be more in line with NGC's detailed charging methodology and consultations, which contain significantly more detail and numerical examples. This respondent suggested that Transco should publish a range of information including:

- SO and TO target revenue recoveries under the price control and a forecast of how each revenue stream would be recovered from different SO and TO charges;
- all assumptions underlying any forecasts including forecasts of throughput and assumptions about how revenues may be profiled within year; and
- any over / under recovery being carried forward from the previous year of the control.

This respondent considered that SO and TO charges could be kept constant throughout the charging year and could be adjusted on an annual basis in a single rebate. The SO / TO charge would only be changed in the event that, relative to forecast, it appeared likely that revenue would be under recovered by more than 25 per cent over the year as a whole.

Floor prices and short-run marginal costs

One respondent supported Transco's proposal for a floor price for the combined SO and TO commodity charges, while another respondent queried why the proposed floor price for charges was linked to short-term marginal costs rather than longer-term investment costs. One respondent suggested that the TO commodity charge should be subject to a cap and collar, in order to protect both Transco and customers.

Retention of buy-back fund

Of those respondents who supported the proposal, the majority suggested that it should exist alongside the buy-back fund mechanism. One respondent, who was against the proposal, suggested that Transco should retain the buy-back fund mechanism and reduce the trigger over recovery level to four per cent.

Adjusting exit capacity charges

Several respondents welcomed the proposal's intended effect of avoiding adjustments to exit capacity charges and one respondent stated that adjusting exit capacity charges may reduce the differential between firm and interruptible charges, thereby obscuring the signals on the price of interruption.

Transco's views

Mechanics of setting the charge and volatility in charges

Transco did not consider that its proposal would lead to increased uncertainty for shippers and suppliers. It argued that since it has a licence obligation to not exceed its price control revenues, the proposal provided a necessary method of adjusting the level of charges.

Transco acknowledged concerns about volatility in charges. Transco considered, however, that the only adjustment to NTS transportation charges in the present year had been a re-balancing between SO (commodity) and TO (exit capacity) charges, which followed publication of Ofgem's proposed modifications to Transco's GT licence.

Floor prices and short-run marginal costs

Transco considered that the proposed floor price was consistent with its relevant objective of cost reflectivity and would avoid undue discrimination.

Retention of buy-back fund

Transco agreed that it would be beneficial to retain the current PC 65 methodology in conjunction with a TO commodity charge, because it would enable a greater level of excess auction revenue to be re-distributed, by offsetting shippers' exposure to buy-back costs, which it argued may be regarded as consistent with stable transportation charges.

Price differential for exit capacity charges

Transco stated that there was a need for a new commodity charge because its only alternative method to deal with TO revenue distribution would be through a reduction in exit capacity charges. Transco argued that such a reduction would have an impact upon firm transportation charges only and would therefore reduce the differentials between firm and interruptible transportation charges. Transco considered that this would be inconsistent with its licence obligations to produce a cost-reflective charging methodology.

Transco's final proposals

In its pricing consultation report, Transco's final proposal provides for the following:

- the existing PC 65 / PC 67 (buy-back fund) methodology to be retained;
- an NTS TO commodity charge to be introduced from 1 April 2003;
- Transco to set the level of the NTS TO commodity charge to reflect the forecast level of TO revenue relative to the maximum allowed under the Transco NTS TO price control formula, taking into account the impact of the PC 65 / 67 methodology. If excess auction revenue were greater than the buy-back cost target set by Ofgem for a particular year, a negative TO commodity charge would be set;

- the NTS TO commodity charge to have an identical structure to the NTS SO commodity charge, i.e. from 1 April 2003 on the basis of exit flows and from 1 October 2003 on the basis of both entry and exit flows on a 50:50 basis;
- the minimum negative NTS TO commodity charge to be such that, in combination with the NTS SO commodity charge, the combined effective NTS commodity rate would not be lower than short-run marginal costs (0.0022p /kWh). Where the combined TO and SO commodity charge was equal to this floor level, Transco would reduce exit capacity charges if it believed this was necessary to comply with its licence;
- the NTS TO commodity charge to be positive if it is clear that auction revenue was likely to lead to an under-recovery; and
- the present billing arrangements for the SO commodity charge to continue, with shippers billed on the basis of the combined effect of the SO commodity charge and the TO commodity charge.

Ofgem's views

Having carefully considered this pricing consultation and the respondents' views, we have decided to veto the proposal.

Certainty in transportation charges

Ofgem is generally supportive of the concept of a revenue rebalancing charge to address over or under recoveries in TO revenues. Further, Ofgem also agrees that it would be inappropriate to adjust exit capacity charges in the event of a TO over or under recovery.

However, Ofgem considers that the proposal has been insufficiently developed and in its current form lacks transparency as to the methodology that Transco would use in setting the charge. In particular there is little certainty as to how Transco would determine its revenue forecasts and the criteria that Transco would apply in deciding to vary the charge. In this respect, Ofgem recognises the concerns expressed by respondents that the proposal in its current form is likely to lead to uncertainty and potentially volatility in the proposed charge.

In particular, Ofgem considers that this uncertainty will make the level of the charge difficult to predict, in turn making it difficult for shippers and suppliers to set prices. As such, Ofgem does not believe that compliance with the proposed pricing methodology will facilitate effective competition between gas shippers and gas suppliers in accordance with Transco's relevant methodology objectives set out in Standard Condition 4A.

Ofgem notes that NGC follows detailed arrangements for setting its balancing services use of system charge, which is calculated daily, on the basis of a forecast level of costs, with an annual reconciliation. Whilst a daily calculation of the charge may not be necessary in the case of the TO commodity charge, Ofgem nevertheless considers that this methodology provides some certainty to electricity market participants.

Going forward, Ofgem believes that the concept of the TO commodity charge has merit. In this respect Ofgem believes that Transco could consider re-introducing this proposal accompanied by a sufficiently specified and detailed methodology to assist shippers in determining the circumstances in which the charge may vary and to assist shippers' understanding of the method by which Transco sets its revenue forecasts.

In addition, Transco could give consideration to proposals that provide for a TO commodity charge (and, for that matter, all other transportation charges) to be revised once a year only with sufficient notice being given to shippers of this change accompanied by information, where appropriate, that would assist shippers in forecasting the likely level of this charge.

Floor prices

Ofgem has concerns that the application of the proposed floor price may lead to reductions in exit capacity charges in the event that combined SO and TO commodity charges reach the proposed floor price. Any re-distribution through adjusting exit capacity charges would affect the differential between firm and interruptible exit capacity charges and impact upon Transco's transitional exit capacity incentives.

In conclusion, Ofgem has decided to veto this proposal for the reasons given above.