

Pricing Consultation Paper PC76

NTS TO Entry Capacity Auction Reserve Prices and Exit Charges

1. INTRODUCTION

The recently modified regulatory framework applicable from April 2002 has introduced new requirements on Transco with regard to offering for sale entry capacity and developing the exit regime. In light of these changes, it is appropriate to consider whether entry capacity reserve prices should still be applied and whether the methodology whereby reserve prices and exit charges are set should be changed.

The paper concludes that it is appropriate to continue to set reserve prices for auctions of entry capacity, and that these should be related to the incremental cost of transmission capacity. It is proposed that the methodology for determining the entry capacity reserve prices should be changed so as to set Monthly System Entry Capacity (MSEC) reserve prices based on the level of the Unit Cost Allowance for each entry point as set out in Transco's Gas Transporters (GT) Licence. With regards to NTS exit capacity charges, it is proposed that, in light of the potentially significant changes to the exit regime that may be introduced by the move to Universal Firm Registration of NTS exit capacity, no rebalancing of firm exit charges should be undertaken until such a move is introduced.

2. LICENCE REQUIREMENTS

The Licence under which Transco operates requires that where transportation arrangements are established by auction either:

- a) no reserve price is applied, or
- b) that reserve price is set at a level –
 - a. best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and
 - b. best calculated to promote competition between gas suppliers and between gas shippers.

As part of the Licence modifications implemented with effect from April 2002, the GT Licence also requires Transco to offer for sale all obligated capacity in at least one clearing allocation unless such an allocation would contravene wider Licence requirements, one of which is that compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers. A clearing allocation is an allocation which either:

- a) results in all the capacity offered for sale being sold; or
- b) has a reserve price of zero.

Auctions promote competition for the products on offer and enable those products to be gained in a non-discriminatory manner between competing parties. In Transco's view, essential requirements of a non-discriminatory auction are measures to mitigate against potential market power. To that end, reserve prices are a standard means of preventing the impact of dominant players exercising market power. This requirement may be considered to be particularly relevant for a regulated monopoly such as Transco where revenue shortfalls resulting from an auction may be expected to be paid for by increasing transportation charges. This necessarily introduced distributional effects, which in some circumstances might be regarded as unduly discriminatory, and may be regarded as contrary to facilitating effective competition between gas shippers and between gas suppliers.

In the MSEC auctions held to date, reserve prices have been applied based on Transco's estimates of long run marginal transmission costs, which were positive for most entry points. This approach was established in light of the issues set out above, and in particular seeks to ensure that services are not provided substantially below the cost of provision.

Table 1 below shows, for the auctions of 2002/03 MSEC, the amount of capacity sold as a proportion of the capacity offered for sale at each major entry point. These are the first auctions in which Transco has offered for sale quantities consistent with the baseline capacities set out in its GT Licence. These quantities were established by Ofgem with a view to reflecting the maximum physical capability at each entry point.

Table 1 : Capacity Allocated in MSEC Auctions

Percentage of Offered Capacity Allocated		
ASEP	% MSEC Capacity Allocated Summer 2002	% MSEC Capacity Allocated Winter 2002/03
Bacton	50%	65%
Barrow	53%	100%
Easington	18%	47%
St Fergus	97%	100%
Teesside	61%	71%
Theddlethorpe	23%	33%
Other	7%	26%
Total	48%	66%

The only entry point at which all, or almost all, of the entry capacity offered has been allocated in each of the last two MSEC auctions has been St. Fergus. In most months, therefore, the MSEC auctions at St. Fergus have been clearing allocations as defined in Transco's GT Licence.

Transco considers that the fact that a large proportion of the capacity offered has not been allocated reflects the balance of supply and demand, and suggests there is a general lack of effective competition given the level of capacity which has been offered. It may be hypothesised that, had a zero reserve price been applied in the auctions for all the entry points then, due to the lack of effective competition, capacity at entry points with non-clearing allocations would have been allocated at, or close to, zero. Transco considers that

such an outcome, with substantial entry capacity prices paid at one entry terminal and prices below cost at all others, could be regarded as unduly discriminatory and would not facilitate effective competition between shippers. For the last two MSEC auctions, it is therefore considered that, for entry points where all the capacity was not sold and where reserve prices were not zero, setting a zero reserve price in order to achieve a clearing allocation would have contravened Transco's wider Licence obligations.

Transco therefore concludes that it is appropriate to continue to set reserve prices for MSEC auctions based on estimated transmission costs. Ofgem has indicated a similar view with regard to electricity transmission access rights in its Initial Consultation on the NGC SO Incentive Scheme, where Ofgem states "under Ofgem's proposals for the reform of the transmission access regime, market participants would be entitled to be allocated firm transmission access rights (entry rights for generators and exit rights for the demand-side) at prices related to the costs of providing the transmission capacity, provided that the total allocation of access rights does not exceed the baseline transmission capacity."

Following from this conclusion, it is necessary to consider the appropriate transmission cost basis to which reserve prices should be related.

3. ENTRY CAPACITY RESERVE PRICES

Entry capacity reserve prices are currently determined by Transco's LRMC methodology which reflects the costs of reinforcing the NTS network to transport additional gas between entry and exit points. (Details of this approach are documented in 'Section 3' of 'Gas Transportation Charges from 1 October 2002', available on Transco's web site, www.transco.uk.com, under Our Publications.)

Within the Licence under which Transco operates, the level of additional revenue which Transco may retain in relation to permanent obligated entry capacity made available above the baseline level at any system entry point has been established by Ofgem. These allowed revenues are determined from Unit Cost Allowance (UCA) factors for each system entry point. These UCAs were determined by Ofgem based upon incremental cost analysis undertaken by Transco, and Transco believes they represent Ofgem's view of the costs Transco could reasonably be expected to incur in undertaking additional investment.

For the forthcoming auction of Long-Term System Entry Capacity (LTSEC), due to be held in January 2003, the minimum price at which the baseline level of entry capacity will be made available will be equivalent to the UCA (assuming an annuity discount factor of 6.25% per annum). Transco proposes that reserve prices for auction of MSEC covering the period from 1 April 2003 should also be set in relation to the UCA.

This change would ensure that MSEC reserve prices reflect a consistent, and independent, assessment of the incremental costs of providing capacity at each entry point. It would also provide consistency between the MSEC reserve price and the LTSEC baseline capacity price, and hence avoid potential market distortions. If the MSEC and other reserve prices were to continue to be set on the present basis, the variation in reserve price between the auction types might create an unintended incentive for shippers to participate in the MSEC auction rather than LTSEC auction, or vice-versa, and so possibly distort the signals relating to entry capacity requirements at each entry point.

To illustrate the potential variation, Table 2 below compares the level of the 2001 LRMCs and the UCAs.

Note that the 2001 LRMCs shown have been scaled so as to be at the same average level as the UCAs.

Table 2 : Comparison of LRMCs and UCAs

All values in p / kWh / day		Present Reserve	LRMC 2001	UCA 2002
Entry – Beach	Bacton	0.0006	0.0040	0.0056
	Easington / Rough	0.0020	0.0003	0.0011
	Theddlethorpe	0.0008	0.0003	0.0010
	St Fergus	0.0189	0.0215	0.0198
	Teesside	0.0047	0.0035	0.0018
	Barrow	0.0023	0.0002	0.0004
Entry – Onshore Fields	Hatfield Moors	0.0026	0.0011	0.0013
	Wytch Farm	0.0000	0.0000	0.0000
	Caythorpe	0.0020	0.0023	0.0021
	Burton Point	0.0000	0.0000	0.0001
	Hole House Farm	0.0002	0.0000	0.0001
Entry – Storage	Hornsea	0.0028	0.0047	0.0047
	Glenmavis	0.0088	0.0153	0.0165
	Partington	0.0007	0.0000	0.0003
	Aldborough	n/a	0.0013	0.0018

Were reserve prices to be set based on the present methodology and reflecting fully-rebalanced LRMCs determined in the traditional manner, then there would be substantial rebalancing from the present level of entry capacity reserve prices. In general this rebalancing would be greater than the variation between the LRMC and UCA derived reserve prices.

For 2003/04, if all the MSEC capacity were sold at the UCA reserve prices then the level of revenue obtained would be approximately 89% of the target TO entry revenue for 2003/04. The percentage of the target revenue obtained at these reserve prices might vary from year to year. The present MSEC reserve prices are scaled so as to recover 75% of the target revenue, were they to be applied to the level of capacity offered. Transco's initial view is that it would be better to set the MSEC reserve prices to the UCA values without any scaling so as to give reserve prices identical to the baseline LTSEC prices. However, respondents' views are sought on whether the MSEC reserve prices should be identical to these UCA values or whether the UCAs should be scaled, for example to recover a predetermined level of the target revenue, such as 75% as at present. The actual level of entry capacity revenue obtained will of course depend upon the outcome of the auctions.

Present DSEC reserve prices are further discounted from the MSEC reserve prices and Transco proposes that the relative relationship between MSEC and DSEC reserve prices should be retained. The DSEC reserve price would thus remain at two thirds of the MSEC price (the DSEC and MSEC reserve prices being at present 50% and 75% of the LRMC

level). Table 3 below details the indicative MSEC and DSEC reserve prices based upon the MSEC reserve price being the UCA level.

Table 3 : Reserve Prices April 2003

All values: p / kWh / day		Reserve Prices April 2003	
		MSEC	DSEC
Entry – Beach	Bacton	0.0056	0.0037
	Easington / Rough	0.0011	0.0007
	Theddlethorpe	0.0010	0.0007
	St Fergus	0.0198	0.0132
	Teesside	0.0018	0.0012
	Barrow	0.0004	0.0003
Entry - Onshore Fields	Hatfield Moors	0.0013	0.0009
	Wytch Farm	0.0000	0.0000
	Caythorpe	0.0021	0.0014
	Burton Point	0.0001	0.0001
	Hole House Farm	0.0001	0.0001
Entry - Storage	Hornsea	0.0047	0.0031
	Glenmavis	0.0165	0.0110
	Partington	0.0003	0.0002
	Aldbrough	0.0018	0.0012
Entry – Constrained LNG	Avonmouth	0.0020	0.0013
	Dynevor Arms	0.0000	0.0000
	Isle of Grain	0.0058	0.0039

Under the proposal to set the MSEC reserve prices in relation to the unscaled UCA values, the reserve prices would remain at the same level for each auction, until the UCAs as used within the Licence were themselves changed, and so this would provide additional stability relative to using reserve prices determined under the present methodology

Transco does not propose altering the present position with regard to Daily Interruptible System Capacity (DISEC) which will continue to be offered at a zero reserve price.

4. EXIT PRICES

Exit capacity charges are set at present using the ‘Transcost’ model as for the present entry capacity reserve prices except that the resulting values are administered charges rather than being used to determine reserve prices. Using the same analytical basis as used to determine the entry UCA values, the resulting exit charges based on the UCA analysis would imply significant variations in exit capacity charges for particular exit points from those at present.

In the light of the potentially significant changes to the exit regime that may be introduced by the proposed move to Universal Firm Registration of NTS exit capacity, as defined in Transco’s Licence and which Transco will endeavour to introduce from 2004, Transco considers that such significant changes to the balance of exit charges at the present time might be inappropriate. Instead, Transco believes that it may be more appropriate for any

move to firm exit charges which are significantly rebalanced from those at present to coincide with when such an exit regime is introduced. This proposal would also enable greater notice of the potential rebalancing to be given so that contractual changes could be made by Shippers and end consumers in good time.

Transco therefore proposes that the existing balance of exit charges should be retained. For April 2003, where an indicative average increase of 2% to the level of exit charges is proposed, Transco consequently proposes to increase each of the existing exit charges by 2% (subject to rounding).

To illustrate the potential impact were an approach consistent with the UCA methodology to be adopted, Appendix 1 details the indicative exit charges proposed for April 2003 and potential exit charges derived under the revised process.

Transco welcomes views on whether, instead of adjusting the existing exit charges by 2%, it would be preferable to base the exit charges on the same analytical basis as the UCAs derived for each entry point.

QUESTIONS FOR CONSULTATION

Transco seeks views on the following proposed changes to its Transportation Charging Methodology:

- **That reserve prices for NTS TO entry capacity should be based on the UCAs specified in Transco's GT Licence;**
- **That MSEC reserve prices should be equal to the annuitised equivalent of the UCAs assuming an annuity discount factor of 6.25% per annum;**
- **That the relationship between MSEC and DSEC reserve prices remain as at present, with DSEC reserve prices at each entry point equal to two thirds MSEC reserve prices at each entry point;**
- **That the existing balance for exit capacity charges should be maintained, rather than rebalancing exit capacity charges, until Universal Firm Registration of NTS exit capacity is introduced.**

Appendix 1

Potential exit charges based on UCA analysis and indicative exit charges for April 2003

Exit Zone	Exit charges if based on UCA-type analysis	Indicative Exit charges: 2% increase on Oct 2002 Charge
EA1	0.0002	0.0024
EA2	0.0072	0.0086
EA3	0.0003	0.0031
EA4	0.0068	0.0093
EM1	0.0051	0.0026
EM2	0.0002	0.0006
EM3	0.0071	0.0066
EM4	0.0019	0.0053
NE1	0.0001	0.0001
NE2	0.0017	0.0017
NE3	0.0002	0.0008
NO1	0.0010	0.0001
NO2	0.0070	0.0007
NT1	0.0177	0.0175
NT2	0.0076	0.0114
NT3	0.0126	0.0126
NW1	0.0118	0.0071
NW2	0.0082	0.0063
SC1	0.0000	0.0001
SC2	0.0066	0.0009
SC4	0.0035	0.0001
SE1	0.0065	0.0093
SE2	0.0177	0.0175
SO1	0.0129	0.0121
SO2	0.0163	0.0166
SW1	0.0042	0.0068
SW2	0.0134	0.0130
SW3	0.0158	0.0257
WA1	0.0122	0.0091
WA2	0.0146	0.0156
WM1	0.0055	0.0055
WM2	0.0040	0.0060
WM3	0.0039	0.0066