December 2002

TRANSCO CONSULTATION REPORT ON PC76

NTS TO Entry Capacity Auction Reserve Prices and Exit Charges

1. Transco's Initial Proposal

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, Transco considered whether entry capacity reserve prices should still be applied and whether the methodology whereby reserve prices and exit charges are set should be changed.

In PC76 Transco proposed 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. PC76 sought views on the following proposed change to the transportation charging methodology for determining the entry capacity reserve prices:

- That reserve prices for NTS TO entry capacity should be based on the level of the Unit Cost Allowance for each entry point as set out in Transco's Gas Transporters (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.

PC76 also sought views on the proposal 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.

This report sets out the views received and Transco's response and final proposal.

2. Summary

There were fourteen responses to the consultation paper.

Shippers & Suppliers	
AEP Energy Services	AEP
British Gas Trading	BGT
ConocoPhillips	CON
Entergy Koch	ENT
ExxonMobil	EXM
Innogy	INN
PowerGen	PG
Scottish Power	SP
Scottish & Southern Energy	SSE
Shell Gas Direct	SGD
Statoil	STA
TotalFinaElf	TFE
Other Interested Parties	
Association of Electricity Producers	AssEP
Corus	COR

Eleven respondents supported the proposal that the reserve prices for NTS TO entry capacity, if applied, should be based on the UCAs specified in Transco's GT Licence (AssEP BGT CON ENT EXM INN SP SSE SGD STA TFE). One respondent (PG) did not support the use of UCAs as reserve prices for entry capacity, preferring the present LRMC approach, one respondent (AEP) did not support their use unless they were shown to be robust and one (COR) expressed no opinion.

Six respondents (AssEP EXM INN SSE STA TFE) supported the proposal that the MSEC reserve prices should be equal to the UCAs, one (SP) thought using unscaled UCAs to be equally valid to using scaled UCAs, one (BGT) supported using unscaled UCAs after October 2004 but supported scaling prior to then and three (CON ENT SGD) supported the use of scaled UCAs.

Four respondents (CON ENT INN SP) supported the proposal that the relationship between MSEC and DSEC reserve prices should remain as at present, two respondents (SGD STA) thought DSEC reserve prices should be zero and the remaining respondents did not comment on this part of the proposal.

Ten respondents supported the proposal that the existing balance for exit charges should remain (AssEP BGT CON COR ENT EXM INN SP SSE SGD), one (STA) commented there was not enough information on which to base a decision and the remaining respondents did not comment on this issue.

3. Detailed Responses

3.1 Entry Reserve prices based on UCAs

Five respondents (AEP COR PG STA TFE) either had concerns or requested more information on the differences between the UCA and LRMC approaches. One shipper (INN) expressed concern over the proposed entry price for Bacton. One shipper (STA) felt that Transco should give more information on the impacts of moving to the UCAs.

Transco's Response

The methodology for determining the LRMCs is detailed in 'Section 3' of ' Gas Transportation Charges from 1 October 2002', available on Transco's web site, www.transco.uk.com, under Our Publications. The UCAs have been determined in essentially the same manner, using 'Transcost' to determine the incremental costs of additional capacity. However there have been some differences at the detailed level. Appendix 1 of this report explains these differences and why there is a substantial change for some entry points in the level of the proposed reserve price from that at present applying.

3.2 Use of UCAs or Scaled UCAs to set Reserve Prices

There was a slight bias amongst respondents in favour of setting the MSEC reserve prices at the same level as the UCAs without scaling. One respondent (AssEP) commented that setting the MSEC reserve price below the UCA might lead to an under recovery. Two respondents (BGT SGD) expressed concern that setting the MSEC reserve price equal to the UCA would lead to significant over recovery.

One shipper (CON) commented that the MSEC reserve should be lower than the LTSEC baseline price to reflect the additional risk of having to pay more in a 'pay as bid' auction. One respondent (EXM) stated that allowing the MSEC reserve price to be lower than the LTSEC baseline price would distort the long term supply/investment signal. One respondent (STA) commented that the prices should be equal to improve the investment signals. Another respondent (TFE) supported the same prices for both auctions to avoid confusion over which auction to participate in.

Transco's Response

It is difficult to predict the likelihood of either an over or under recovery of income resulting from the auctions of entry capacity. However Transco believes that setting MSEC reserve prices to be identical to the LTSEC baseline prices, i.e. to the annuitised equivalent of the UCAs set by Ofgem for existing entry points, best meets the licence condition of promoting efficiency and avoiding undue preference in the supply of transportation services. The MSEC reserve prices and the LTSEC baseline prices inform bidders of the relative costs of capacity and bidders can signal where and how much capacity is of value to them. This will encourage economic investment to be made. Any resulting over or under recovery would be dealt with under the existing methodology, initially with the application of the PC65/67 process in the event of over-recovery.

Setting MSEC reserve prices at the same level as the LTSEC baseline prices is in line with reflecting the costs of essentially the same product – entry capacity at existing baseline availabilities. Transco believes that setting different reserve prices could encourage participation in one type of auction relative to another and this might lead to increased price uncertainty and therefore risk to both shippers and Transco. If this encouraged participation in the MSEC auctions rather than LTSEC auctions this might undermine the ability of the LTSEC auction results to signal the desire by shippers for incremental capacity.

Transco acknowledges that there is the possibility that the price actually paid for capacity in the MSEC auctions may be above the reserve price. However, the price paid for the baseline level of capacity in the LTSEC auctions can be higher than the baseline price depending upon the quantities bid at each price step. It is therefore not clear that the risk of paying above the reserve or baseline price is greater in the MSEC auctions.

3.3 Relationship of DSEC to MSEC Reserve Prices

Of those respondents that commented on this issue, four (CON ENT INN SP) supported the proposal that the relationship between MSEC and DSEC reserve prices should remain as at present whilst two (SGD STA) wanted zero DSEC reserve prices. One respondent (STA) considered that a short-term product such as DESC need not have the same restrictions as other products such as QSEC and MSEC since the requirements for buying short term capacity are different from those driving longer term purchases. One respondent (CON) asked if a zero reserve prices would apply to DSEC that was unsold LTSEC. One respondent (SSE) questioned whether it was appropriate to have different reserve prices for DSEC and rolling MSEC. One respondent (AEP) stated that Transco should consider either the rolling monthly or daily auctions having a zero reserve price.

On the issue of the level of competition at different entry points, one respondent (ENT) questioned the definition of competition at entry terminals and stated that reserve prices should only apply at uncompetitive terminals. Another respondent (SGD) also queried Transco's definition of competition at entry terminals.

Transco's Response

Transco considers that there continues to be justification in have positive reserve prices for the allocation of capacity ahead of the day in that they can prevent the impact of dominant players exercising market power and can help to reduce the possibility of significant revenue shortfall from the auctions which might require other transportation charges to be increased, so introducing distributional effects which in some circumstances might be regarded as unduly discriminatory.

However, Transco agrees with the view that the requirements driving short term capacity purchases may be different from those driving longer term purchases and therefore that the same restrictions with regard to reserve prices should not necessarily apply. In light of the responses, Transco considers that there is merit in distinguishing between sales of daily firm capacity made ahead of the day and sales of daily firm capacity made on the day itself. It is therefore proposed that the relationship of the DSEC reserve price to the MSEC reserve price should stay as at present, namely that the DESC reserve price should be two-thirds of the level of the MSEC reserve price, but that

from October 2003 the reserve price for daily capacity sold on the day of the capacity itself should be zero.

On the basis of the present pattern of capacity sales, this proposal has the merit of maintaining the prevention of the impact of dominant players exercising market power and continues to help to reduce the possibility of significant revenue shortfall from the auctions. However, it also ensures that all obligated capacity can be offered for sale in at least one clearing allocation, irrespective of the state of competition for capacity at each entry point.

Transco acknowledges that there is no unique definition of the level of competition at each entry point that is agreed by all parties to be the most appropriate measure.

For the avoidance of doubt, the reserve price for the Rolling MSEC auctions is the same as for the MSEC auctions.

In terms of the auction process, there is no difference between daily capacity that might be made available that might be unsold LTSEC or that might be any other firm capacity. The same reserve price will therefore apply to all daily capacity for a particular day made available at any given time.

3.4 Other Comments

One respondent (INN) questioned why the QSEC auction is volume based whilst the MSEC auction is pay as bid.

One respondent (PG) was concerned about the potential lack of stability from one Licence period to another.

Transco's Response

The LTSEC auctions will offer QSEC, initially from October 2004 through to 2017. In these auctions a variable level of capacity can be made available in the light of the auction signals received and so a volume based auction is considered to be the most appropriate. In the MSEC auctions a fixed level of capacity is made available and so a price auction is most appropriate.

Setting the reserve prices in relation to the UCAs as set by Ofgem will lead to stability over a five year time period. The changes brought into effect from April 2002 reflect the significant changes in Transco's Gas Transporter Licence introduced with effect from that time. The level of change that may be introduced by any future Licence changes is obviously unknown now but Transco agrees that a period of stability in the entry capacity regime would be beneficial.

4. Conclusion

Transco welcomes the comments received in response to the proposals contained within PC76. It is clear from the responses received that there is a wide variety of views on many of the issues raised within the consultation paper. However the respondents have shown a slight bias in favour of moving to the UCAs for entry reserve prices. Transco believes there are benefits in having consistent signals through consistent prices in both the MSEC and LTSEC auctions.

Transco's final proposal is:

- **That from April 2003 MSEC reserve prices should be equal to the baseline price for capacity offered in the auction of QSEC capacity;**
- **That the relationship between MSEC and DSEC reserve prices remain as at present, with DSEC reserve price at each entry point equal to two thirds MSEC reserve price at each entry point;**
- **That from October 2003, the reserve price for daily firm system entry capacity sales sold on the day of the capacity itself should be zero with the reserve price for DSEC sales ahead of the day remaining equal to two thirds MSEC reserve price 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

Differences between UCAs, Standard LRMCs and Present Reserve Prices

The UCAs have been determined by Ofgem from incremental cost analysis provided by Transco. As can be seen from Table 2 in PC76 the incremental unit costs determined from the UCA analysis and the LRMCs which would be calculated in the traditional manner for determining reserve prices are similar for most entry points. This similarity is to be expected since the UCA and LRMC figures are determined using the same basic approach, namely:

- the use of Transcost to determine the marginal costs;
- the use of the same forecast base supply and demand levels for the analysis, the 2001 Base Plan forecast, with the same base pipeline network
- analysis over the same ten year period 2002/3 to 2011/12
- the same forecast unit costs have been used for the incremental pipeline and compressor costs

The main differences between the analysis approaches are:

- the use of a 6 mcmd increment size for the UCA analysis instead of the 2.83 mcmd increment used for the standard LRMC analysis;
- the manner of determining average entry unit costs from the analysis. For the UCA analysis entry and exit unit costs were fitted to the results for each year and a simple average entry unit cost was then calculated across the ten years. For the traditional LRMC determination weighted average costs are first calculated for each route across the ten years and then entry and exit unit costs are fitted to these average costs.

There are larger differences between the balance of the present reserve prices and the latest LRMCs or UCAs than between the LRMCs and UCAs. The main reason for these differences is that the present reserve prices reflect the balance of administered entry charges that would have applied if administered charges were still used. The methodology for determining the administered entry charges includes limiting the degree of change from one year to the next so that, where there are substantial changes in the balance of derived LRMCs from one year to the next the administered charges (and thus reserve prices) will not fully reflect the latest LRMCs. This process has ensured a degree of stability to the administered charges, and now reserve prices, but has meant that there is a difference between the reserve prices set at any time and those which would reflect fully the latest derived LRMCs.

The process for rebalancing the administered charges was set out in Appendix B of PC71, which sets out the present methodology for determining the NTS TO charges. It was noted in Appendix B of PC71 that there were substantial changes in the balance of LRMCs derived from the 2000 and 2001 analyses which reflected the changing pattern of capacity constraints on the pipeline system as a result of the changes in the pattern of forecast demand and supply, notably the forecast increase in the level of supplies coming in through the European Interconnector. This resulted in 2001 LRMCs which were substantially higher at Bacton but much lower at all the other major entry points other than St Fergus compared to the 2000 LRMCs, as shown in Table 1 of PC71. However the smoothed rebalancing process limited the degree of change in the reserve prices applied for the allocation of April 2002 capacity onwards.