July 2003

Pricing Consultation Paper PC77

NTS TO Commodity Charge

1. Introduction

In PC75 Transco proposed the introduction of a TO commodity charge. This proposal was vetoed by Ofgem as a result of concerns about the lack of transparency and certainty in how the proposed charge would be set and adjusted. However, Ofgem recognised that such a charge may be appropriate, provided these issues were addressed. Having considered these points carefully, and consulted with the Industry via PD17, we are now issuing this consultation paper with a view to the potential introduction of a TO commodity charge from December 2003.

2. Background

Under the regulatory framework that has applied since April 2002 there are separate limits on NTS TO, NTS SO and LDZ revenues. Pricing Discussion document PD17 discussed the setting of NTS Transportation charges and the mechanisms available in the event of expected over/under recovery in revenues. Licence requirements to set charges that aim not to over recover and year-on-year Licence restrictions on revenue could potentially necessitate frequent changes in price levels. Specifically with regard to the NTS TO there is considerable uncertainty in the level of expected revenue. The most significant factor is the uncertainty in the revenue from entry charges, which is dependent on auction outcomes.

The present transportation charging methodology for handling entry capacity auction revenue in excess of the target level is defined by PC65, as amended by PC67 (and referred to here as the "PC65 mechanism"). In summary, a credit is paid to each User in relation to their monthly MSEC holdings up to the level, in total, of the excess revenue or the aggregate User buy-back costs, whichever is the lower. Where the auction excess is greater than the aggregate User buy-back costs then Transco may adjust other transportation charges so as to aim to not over-recover against its maximum allowable NTS TO revenue. The uncertainty of the capacity buy-back costs makes it difficult to make such adjustments with certainty to the end of year recovery position.

At present, the flexibility for adjustments to other transportation charges in response to deviations from target levels of entry capacity auction revenue (either above that which can be dealt with under the PC65 mechanism or in the situation of under-recoveries) is limited to NTS exit capacity charge adjustments.

3. Summary of Proposal

This paper describes a proposed change to the transportation charging methodology in which an NTS TO commodity charge would be created, along the lines discussed in PD17. If the NTS TO revenue obtained from the other charges were in line with target levels then it would be expected that the NTS TO commodity charge would be zero. If the NTS TO revenue were out of line with the target level, due to entry auction revenue levels or other factors, then the NTS TO commodity charge could be adjusted accordingly. The NTS TO commodity charge could be positive or negative, although a limit would be set on the extent of its negativity. This methodology would take precedence over that established by PC65. However, the PC65 mechanism would be retained for situations where the limit on the negativity of the NTS TO commodity charge rate meant that a further adjustment to revenues was required.

4. Discussion

<u>Advantages over PC65 mechanism</u>

There are several drawbacks with the PC65 mechanism as the primary mechanism for adjusting NTS TO revenues. First, it only operates in situations where the auction implied revenue is more than 10% above the target level. It is not applied in cases where the auction implied revenue is below the target level or less than 10% above the target level. Second, by smearing revenue back in proportion to capacity holdings, this mechanism may distort the auction bidding process. Third, since the excess revenue is returned to shippers in relation to the buy- back costs in each relevant month the actual level of revenue returned varies considerably and is difficult to predict. With the existing transportation charging methodology, Transco's only other tool is to adjust the NTS exit capacity charges in response to either a large excess or shortfall of TO entry capacity auction revenue above or below target.

<u>Issues with adjustments to NTS exit capacity charges</u>

Several concerns have been expressed regarding the use of exit capacity charges as a means of balancing NTS TO revenue.

First, any adjustment would impact solely on firm transportation charges and would therefore affect the differential between firm and interruptible transportation charges.

Second, Transco's incremental exit capacity incentive scheme provides an incentive to reduce the level of exit revenue foregone in respect of interruptible supply points against a target revenue level based upon the then prevailing level of exit capacity charges. Reducing the exit capacity charges in response to a high level of excess TO entry auction revenue might be considered to be an inappropriate means of improving performance against this target. Increasing exit capacity charges in response to shortfalls in revenue would have the opposite effect.

Third, exit capacity charges provide a signal of the relative incremental cost of providing capacity for new loads in differing locations. Adjusting exit charges for the purpose of balancing total NTS TO revenue is counter to the desire to provide locational exit signals that are as stable as possible.

The introduction of an NTS TO commodity charge would avoid the above problems. The charge would be a more appropriate mechanism for the adjustment of revenues since it would apply to all loads (so maintaining the firm – interruptible differential), would not directly impact on the SO incentive scheme, and would not affect locational signals. For these reasons, the TO commodity charge would be consistent with Transco's Licence objectives of reflecting the costs incurred by Transco and taking account of developments in the transportation business.

Outcome of PD17

PD17 raised a number of issues associated with charge-setting, including the possible introduction of a TO commodity charge. The majority of the respondents to PD17 who commented on this possibility were supportive of it, for many of the reasons already discussed. However, two respondents were concerned that the charge would lead to more uncertainty for shippers. Furthermore, the majority of respondents were in favour of increased stability with as few as possible price changes during the year and as much notice of changes as possible.

In our view, the uncertainty associated with future charges is driven to a large degree by the entry auction process. In the absence of a TO commodity charge, it is uncertain to shippers whether the PC65 mechanism will operate (and to what extent), or whether exit charges will have to be amended in order to adjust total NTS TO revenue in line with price control limits. Furthermore, limitations on these existing mechanisms are more likely to lead to significant levels of under- or over-recovery, which would tend to increase the volatility of charges over time. We therefore believe that a TO commodity charge, which would be clearly established as the primary mechanism for adjusting revenue, would increase both the certainty and stability of charges overall. We believe that this is consistent with our Licence objective of facilitating effective competition between gas shippers and between gas suppliers. In addition, the introduction of annual MSEC auctions should allow us to restrict the frequency of changes in charge levels to once a year, except in extreme circumstances.

5. Implementation issues and relationship with other charges and mechanisms

Relationship with PC65 mechanism

There are three options for how an NTS TO commodity charge could be introduced in relation to the PC65 mechanism:

(a) The PC65 mechanism could be discontinued;
(b) The NTS TO commodity charge could be the primary mechanism for adjusting revenues, with the PC65 mechanism retained if required over and above application of the TO commodity charge; or
(c) PC65 could remain the primary mechanism for handling potential over-recoveries, with the NTS TO commodity charge applied if the level of excess revenue were greater than the PC65 methodology could handle.

In our view, option b) is preferable. The introduction of an NTS TO commodity charge as the first method of adjusting the predicted revenues to target revenues reduces the drawbacks detailed above with the PC65 mechanism. In particular, it provides a more certain method of making adjustments within the same formula year. However, retention of the PC65 mechanism should it be required (i.e. if it is not possible to reduce the NTS TO commodity charge sufficiently to avoid over-recovery) seems a sensible contingency measure.

At present, the PC65 methodology does not automatically operate unless the excess auction revenue is greater than 10% over target. Where it does operate the total amount of revenue above the auction target is allocated for potential return through the mechanism to shippers. Under the proposed approach, whereby the NTS TO commodity charge would be used in preference to the PC65 mechanism, we would propose to apply the same rule should the NTS TO commodity charge be insufficient to avoid a forecast over-recovery. In other words, in those circumstances the PC65 mechanism would then automatically apply only where the excess auction revenue was more than 10% above the target.

Charging base

It is proposed that the TO commodity charge would be applied on an identical basis to the SO commodity charge. Issues associated with the appropriate charging base for the SO commodity charge have been the subject of recent consultation processes, and apply equally to the proposed TO commodity charge. At present, the SO commodity charge is levied on exit flows only. Subject to Ofgem's direction in relation to Mod 626 the SO commodity charge could in the future apply to entry and exit flows (with the same rate applicable to entry and exit such that roughly 50% of the revenue relates to each of entry and exit). Should that happen, the TO commodity charge would be also be applied to this revised charging base.

Application of the TO and SO commodity charges on the same basis would also have benefits through ease of invoicing and administration.

As noted above, the NTS TO commodity charge could be negative. However, our intention would be to limit the extent of its negativity such that, in combination with the NTS SO commodity charge, the combined effective NTS commodity charge rate would not be lower than the estimated short-run marginal cost of operating the NTS. This would ensure that the combined commodity charge would not encourage inefficient use of the NTS.

Relationship with Optional SO Commodity Tariff

The optional commodity tariff is available as an alternative to the standard commodity tariff, and can be attractive in relation to large supply points situated close to entry points. It is proposed that the optional commodity tariff would continue to be available. Thus for a shipper electing this tariff, the tariff would be payable in place of the combined TO and SO commodity charges that would otherwise apply. This would be consistent with the intent at the time of introduction of the optional commodity tariff, which was to provide an alternative to the NTS commodity charge. Additional merits of this approach are the simplicity of having a TO commodity charge that can be applied on an identical basis to the SO commodity charge and avoidance of complexity that would otherwise arise in the situation of a negative TO commodity charge.

6. Proposed method of operation of an NTS TO Commodity Charge

General approach

In broad terms, we would aim to set NTS exit capacity charges, as now, to recover 50% of the NTS TO target revenue. The remaining 50% would be the target for auction revenue to be raised from entry capacity. On the assumption that the target revenue for entry capacity is achieved the TO commodity charge would be set to zero.

Following the auctions for MSEC we would review the forecast revenue position and, if necessary in order to avoid a significant over- or under-recovery, we would consider adjusting the TO commodity charge (subject to the normal two months notice period).

In the case of a forecast over-recovery, the TO commodity charge could be set at a negative value to bring the predicted revenue back to the target level. On the assumption that the combined TO and SO commodity rate should not fall below the marginal costs of running the system (most recently estimated as 0.0022p/kWh) a large forecast over recovery may necessitate a further price adjustment. In this instance the PC65 methodology would be retained and applied as the secondary tool for adjustment. In the event that there was still a predicted over recovery a reduction in the exit capacity charges could be used as the third tool.

From 2004, MSEC auctions will be held annually in February. As indicated above, we anticipate that the annual auctions will provide sufficient clarity to enable us to only amend NTS charges once a year, except in extreme circumstances.

Initial implementation

We are considering two potential methods of adjusting expected revenue towards target revenue, should we forecast a significant level of under-recovery in 2003/04 following the autumn 2003 MSEC auctions:

a) Keep exit capacity charges at the existing level and use the TO commodity charge to balance the forecast level of recovery to the target TO level of recovery for 2003/4. In this case we would expect to adjust exit capacity charges (which are at present below the underlying level necessary for 2004/5) from April 2004.

b) Adjust exit capacity charges from December 2003 towards the appropriate underlying level. If the level of forecast under-recovery warranted it, exit charges could be set at such a level from December 2003 that we would not expect to adjust them again until April 2005. In this case, the NTS TO commodity charge would only be introduced from December if the adjustment to exit charges was insufficient to bring expected revenues in line with the target level.

In either case the level of TO commodity rate would be reconsidered following the 2004 MSEC auctions to be held in February 2004.

7. Questions for Consultation

We would be pleased to receive views on the following proposed changes to our Transportation Charging Methodology:

- **That an NTS TO commodity charge be introduced, additional to the NTS SO commodity charge, which would be used to adjust the level of TO revenue if there is forecast to be significant over- or under-recovery of TO revenue against the maximum allowable TO revenue following the MSEC auctions;**
- **That the NTS TO commodity charge should have an identical structure at all times to the NTS SO commodity charge and that the minimum negative NTS TO commodity charge should be such that, in combination with the NTS SO commodity rate, the combined effective NTS commodity rate should not be lower than the short-run marginal cost of operating the NTS;**
- **That adjustment to the NTS TO commodity charge relating to any excess of NTS entry capacity auction income against target should take precedence over the adjustment methodology established by PC65. The PC65 methodology would be retained for use as the secondary adjustment tool where the combined SO and TO commodity charge would otherwise fall below the short-run marginal cost of operating the NTS system;**
- **That the Optional SO Commodity Tariff remains available, as an alternative to the combined SO and TO commodity charge.**

In addition, we would be interested in views over the two potential options that we have identified for adjusting charges in December 2003, as outlined in section 6.