



Shippers, Transco and other interested parties

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Dear Colleague,

**Pricing Consultation Paper PC 78 - NTS TO Commodity Charge (NTS TO Under-Recovery)**

Transco raised Pricing Consultation (PC) 78 *NTS TO Commodity Charge (NTS TO Under-Recover)* in March 2004 and published its PC 78 report on 30 June 2004.

Ofgem has carefully considered the views of the respondents to this pricing consultation and has decided not to veto this proposal because it appears to better facilitate the relevant objectives of Transco's charging methodology, as set out in amended standard condition 4A of Transco's Gas Transporter (GT) licence.

In making this decision Ofgem has all taken in to account its statutory duties and Transco's obligations under its GT licence.

The background to this decision is set out in the appendix to this letter. The reasons for Ofgem's decision are set out below .

As a result of not vetoing this proposal, a TO commodity charge will be introduced to rebalance TO revenue under recoveries from October 2004. In respect to future over recoveries, the mechanism established under PC65, *Alternative Method of Funding Entry Capacity Constraint Management*, as adjusted by PC 67, *Technical Adjustment to PC65 Mechanism*, will continue to operate.

*Transco's transportation charges*

Transco levies transportation charges on shippers to recover its National Transmission System (NTS) allowed revenues for its transmission asset owner (TO) activities and system operator (SO) role as determined under its price control. In particular, Transco collects its NTS TO allowed

revenue through entry and exit capacity charges and its NTS SO allowed revenue through an SO commodity charge. Transco is required to use its best endeavours in setting its charges to ensure that, in respect of any formula year, the revenue from such charges does not exceed its price controlled maximum allowed revenue for each of its TO and SO controls.

Transco may need to adjust the level of its transportation charges periodically in order to ensure that it meets its price control obligations. Changes of this nature may be required in the event that Transco has incorrectly forecast its expected revenues for a formula year. In addition, where revenues received from entry capacity auctions suggest that Transco may over or under recover its allowed revenue for a particular year, charges may be adjusted to ensure Transco does not over or under recover against its allowed revenue.

### **Transco's initial proposal**

In raising this consultation, Transco proposed to introduce a TO commodity charge to allow for the redistribution of under recoveries of TO revenue. The TO commodity charge would be introduced from October 2004 and it would be set to have a zero rate where forecast NTS TO revenue was in line with, or greater than, target revenue. The Optional NTS SO Commodity Tariff would remain available as an alternative to the combined NTS SO and NTS TO commodity charge. The mechanism established under PC65 would remain in place in case of a NTS TO revenue over-recovery. In particular, Transco invited respondents to submit their views on:

- whether the proposed TO commodity charge should be levied on a split between entry and exit flows, fully on either exit or entry flows, or applied to any alternative charging base, and
- the trade-off between levying a higher under recovery charge for a short period or a lower charge for a longer period.

### **Respondents' views**

The majority of respondents offered support for the introduction of the TO commodity charge to address under recovery of TO revenue. There were mixed views on the appropriate structure of the charge. Some respondents expressed concern on the introduction of the TO charge, and others offered suggestions on how it could operate.

#### *Structure of the charge*

There was no consensus among respondents about the structure of the proposed TO commodity charge. A number of respondents said that the proposed charge should maintain the same structure as the SO commodity charge (a 50-50 split between entry and exit). The main points supporting this argument were that a charge entirely on entry could distort bidding behaviour in the auctions and would be inconsistent with the current revenue rebalancing mechanism in case of over-recoveries (PC65). Some respondents also noted that in the past shippers had benefited from the reduction in charges at exit following over-recoveries of TO revenue.

A number of shippers offered support to a charge levied on entry flows only. The rationale for this approach was that the major cause of under-recovery of TO revenue would normally be the

outcome of entry capacity auctions, therefore a charge applied to entry flows only would be more appropriate.

Additionally, there was support from a number of respondents who suggested that it would be practicable to introduce a TO commodity charge from October 2004 and to re-set the charge to zero from 1 April 2005. Other respondents said the introduction of the proposed charge should be delayed.

#### *Applicability to storage sites*

Transco noted in its consultation report on PC78 that the TO commodity charge would not apply to storage flows at this time but it stated that it intends, in the near future, to consult on transportation charge arrangements at storage points connected to its system. In its decision letter on modification proposal 0626 *Structure of the NTS TO Commodity Charge*, Ofgem stated that in principle storage flows should not be excluded from the application of the SO commodity charge. These issues are still unresolved and consideration should be given to the applicability both of the TO and SO commodity charge to storage. Ofgem would welcome a further consultation by Transco on transportation charge arrangements for storage flows.

#### *Impact on wholesale markets*

The introduction of this additional change to Transco's charges may have implications for shippers and producers with existing gas contracts and may therefore have an impact on the wholesale market. Shippers and other interested parties have been able to participate in the consultation processes concerning TO under and over recoveries since 2002. The consultations have considered the implications of levying a TO rebalancing charge on both entry and exit capacity holders. Ofgem considers that users at both entry and exit would have had at least some opportunity to adjust their contract pricing in the light of this debate.

#### *Other comments*

In summary, some of the other issues that emerged from the consultation were:

- some respondents expressed concerns over a possible detrimental effect on security of supply of a TO commodity charge
- a number of respondents stated their preference for a charge set annually for reasons of stability and predictability
- some respondents considered that the NTS Optional commodity tariff should be retained,
- one respondent proposed NTS TO commodity charge should be levied only in respect of entry flows recorded against daily entry capacity, and
- one respondent believed that the issues of forecast over and under-recovery of TO revenue should be considered at the same time.

#### **Transco's final proposal**

In its consultation report, Transco noted that in the absence of an NTS TO commodity charge to deal with potential under recovery of TO revenue, then NTS exit capacity charges remain the only tool available to Transco in response to a forecast shortfall of NTS TO revenue. Transco considered that this arrangement was not satisfactory and created numerous distortionary impacts.

Transco also noted that, due to the current forecast revenue position, it was not necessary to deal with over recovery in the short term. Therefore it developed proposals for a TO commodity charge to address only under recoveries.

After considering respondents' views, Transco proposed to apply the TO commodity charge to entry flows only and to exclude under-recovery arising from NTS exit charging when setting the charge in its final consultation report.

In summary, in its June 2004 consultation report, Transco proposed:

- that an NTS TO commodity charge be introduced from October 2004. The charge would be used to adjust the level of NTS TO revenue against the maximum allowed NTS TO revenue, that does not arise from NTS exit charging, following the AMSEC auctions
- that the NTS TO commodity charge will be set to have a zero rate where forecast entry capacity revenue is in line with, or greater than, target revenue
- that the NTS TO commodity charge should solely be levied on entry flows
- that the NTS TO commodity charge would be notified by August in respect of the 12 months commencing each October and that Transco would consider departing from this process only if there is a greater than 30 percent under-recovery of forecast auction revenue given the current level of the TO commodity charge
- that the optional NTS commodity tariff remains available as an alternative to the combined NTS TO and SO commodity charge, and
- that the TO commodity charge would not be levied on storage flows.

#### *Implications for offshore producers*

Following the publication of Transco's final proposals, a number of offshore producers sent in additional views, which they have asked Ofgem to take into consideration. The producers considered that the additional charges for entry capacity associated with this proposal would discourage offshore investment in the UK continental shelf region and damage competition.

Some offshore producers also argued that a charge based solely on entry flows would not be acceptable, given that in the past shippers at exit benefited from reductions of charges following a substantial over recovery of revenues in 1999 (amounting to around £400m).

#### **Ofgem's views**

Ofgem agrees with the principle underlying the proposal to introduce a rebalancing charge to deal with over and under recoveries of TO revenue. As stated in Ofgem's decision letters for Pricing Consultation 75 (PC 75) *NTS SO Commodity Charge* and on Pricing Consultation 77 (PC77) *NTS TO Commodity Charge* there is a need for a rebalancing mechanism in Transco's charging methodology to allow for the collection or redistribution of TO revenue under or over recovery resulting from the unpredictability of revenue generated from entry capacity auctions. In particular, it would be undesirable to adjust exit capacity charges in the event of a TO under recovery.

Ofgem considers that this proposal addresses a number of the issues that emerged in previous proposals (PC75 and PC77). In particular, the proposed methodology is transparent, and it provides an adequate level of stability of charges. Ofgem notes that Transco proposes to set this

charge once a year and intends to provide notice of any change in charges by August of each year.

It is Ofgem's understanding that for this year, Transco's under recovery can be attributed back to entry capacity auctions. Given that exit charges are set on an administrative basis, the proposed charge allows for better targeting of under recovery by levying the charge on entry capacity holders.

Ofgem is not convinced by arguments raised by upstream market participants that this proposal would unduly discourage offshore investment. Recovering a short-fall in revenue from entry capacity auctions from an additional entry capacity charge reflects the overall costs of entry capacity on the National Transmission System. Similarly, the PC 65 mechanism exists to provide entry capacity holders with credits where there is an entry driven TO over recovery. These methodologies should provide a transparent and cost reflective approach to redistributing the costs of providing and maintaining a national transmission system and so should not unduly discourage investment or distort competition.

Some producers consider that they should not be penalised for an under recovery, following the redistribution of the 1999 and 2000 over recoveries through exit charges. Given the developments to the auction regime since 2000, Ofgem considers that it is important that charging arrangements are forward looking. As the auctions and charging arrangements have developed significantly since 1999 it is unlikely that these circumstances would arise again.

Ofgem considers that it is important that the structure of charging arrangements and the recovery of revenues reflect underlying costs in an appropriate way. Transco's final proposal on PC 78 addresses a number of issues, by providing adequate notice and stability in charging by proposing changes to charges in October and April of each year and by proposing to structure the charge as a throughput charge based upon entry capacity flows, thereby targeting the revenue flow from entry TO revenue under-recoveries back to entry capacity holders at this point in time.

Ofgem also notes that in its final proposals, Transco stated that it intends, at a later date, to consult on NTS TO revenue over-recovery, including a review of the existing PC65 mechanism. Without fettering its discretion, Ofgem would welcome this consultation.

The TO commodity charge appears to allow Transco to better achieve its relevant charging methodology objectives as set out under amended standard condition 4A of its GT licence. Ofgem has therefore approved this proposal, with effect from October 2004.

### **Ofgem's decision**

The long-term entry capacity auctions have the advantage of allowing shippers to secure long-term firm capacity rights, providing signals for long-term network investment and by creating transparency in the pricing of capacity at each terminal. However, these arrangements need to be consistent with Transco's price control revenue allowances, which have been designed to allow it to finance its activities.

There is merit in introducing a TO commodity charge under Transco's proposed framework and targeting the charge on entry capacity consistent with a cost reflective approach to charging.

Given the introduction of long-term and annual auctions, there is less of an incentive for shippers to strategically bid in auctions and to hold capacity in order to directly benefit from an over recovery or to bid in order to avoid an under recovery.

Overtime it may be necessary for Transco to revisit its charging methods and to continue to ensure that they reflect developments in the revenue recovery mechanisms within the entry and exit regimes. In particular, Ofgem considers that the TO commodity charge could be further developed at a later stage to reflect any TO under recoveries that might result from exit capacity arrangements.

On this basis Transco's proposals for a TO commodity charge provide the transparency, stability, are consistent with effective competition between relevant shippers and suppliers. It also facilitates the economic and efficient operation of the pipeline system by targeting its TO commodity charge on those shippers who hold entry capacity relating to Transco's 2003-2004 TO under recovery.

If you have any further questions on this letter or the accompanying paper, please do not hesitate to contact me on the above number or Tolani Azeez / Matteo Guarnerio on 020 7901 7043/7493.

Yours sincerely

A handwritten signature in blue ink that reads "A Walker". The signature is written in a cursive, slightly slanted style.

**Andrew Walker**

Director, Transmission Networks Regulation

## **Ofgem's views on Transco's proposal to introduce the NTS TO commodity charge – NTS TO under-recovery (PC 78)**

### **Background information to PC 78**

Ofgem published price control modifications to Transco's Gas Transporter (GT) licence on 27 September 2002. 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 separated 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.

As a result of this separation, Transco issued PC 70 *NTS System Operation Transportation Charges*, where it proposed that the standard commodity charge be replaced by SO commodity charge, based on the target level of SO revenue. Initially, the charge was applied to exit flows only but PC 73 *Structure of the SO Commodity Charge* proposed the introduction of a 50/50 split between entry and exit. After Ofgem's decision to implement modification proposal 0626 *Structure of the NTS SO Commodity Charge*, the SO commodity charge will be applied to all entry and exit flows from 1 October 2004.

Under Special Condition 28B of its GT licence, Transco is obliged 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. NTS TO allowed revenue is recovered through the sale of entry capacity rights in annual long-term quarterly (QSEC) and annual monthly (AMSEC) system entry capacity auctions.

### *Over recovery mechanisms*

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 PC 65 Mechanism* and PC 66 *Transportation Charge Adjustments Following Entry Capacity Auctions*.

In the event of an over recovery, PC 65 established a method whereby Transco rebates excess revenue by offsetting shippers' exposure to the costs of buy-backs (the buy-back fund) based upon their end of day entry capacity holdings. The buy-back fund is utilised when auction revenue exceeds target revenue by 10 percent or more. This reduction in the buy back fund tends to benefit those users that have bought entry capacity. Only in the circumstances where an over recovery was very large would exit charges be reduced. Transco has indicated that it will review the components of PC 65 in due course.

PC 66 provided for adjustments to the general level of transportation charges in the event of an under-recovery from entry capacity auctions.

### *PC 75 NTS TO commodity charge*

In July 2002, Transco raised PC 75 *NTS TO commodity charge* which proposed to introduce a TO commodity charge to allow for the redistribution of over or under recoveries of TO revenue. In its final proposal for PC 75, Transco proposed that the existing methodology (PC 65 /PC 67) would be retained and that the TO commodity charge would be set to zero if, after allowing for

the impact of the PC 65/PC 67 methodology, forecast TO revenue was in line with target revenue levels. The level of the TO commodity charge would be set to reflect the forecast level of TO revenue relative to the maximum allowed under Transco's NTS TO price control formula. Finally, Transco proposed that the TO commodity charge would have the same charging base as the SO commodity charge, levied on entry and exit capacity holders and would have a de minimus equivalent to the combined NTS TO and SO commodity charge. Ofgem vetoed this proposal because it considered that it was insufficiently developed and it lacked transparency as to the methodology that Transco would use in setting the charge.

#### *Pricing Discussion Paper PD 17 Setting of NTS Transportation Charges*

In January 2003 Transco published Pricing Discussion Paper PD17 *Setting of NTS Transportation Charge*. Transco re-stated its proposal to introduce an NTS TO commodity charge as a means of adjusting for variations in the level of actual revenues compared to its allowed revenue. Transco sought views from respondents on whether it would be beneficial to introduce a TO commodity charge and the frequency with which such a charge would be re-set. Transco considered that there was merit in all NTS TO charges being set at the same time, covering a whole formula year, including a TO commodity charge which reflected the level of anticipated over or under recovery carried forward to that formula year.

#### *PC 77 NTS TO commodity charge*

In January 2004, Transco raised a second paper (PC 77 *NTS TO commodity charge*) addressing these issues. In its final proposal for PC 77, Transco proposed that the TO commodity charge would be the primary mechanism for dealing with over or under recovery of TO revenue, while PC65 would be kept as a secondary mechanism for dealing with over recoveries. The proposed TO commodity charge would have the same structure as the SO commodity charge. It would be levied on entry and exit and would be set to have a zero rate when forecast revenue was in line with target revenue. Transco again proposed a minimum level of the combined SO and TO commodity charge. Ofgem vetoed this proposal given the ongoing concerns raised by shippers about the potential increased uncertainty about the level of transportation charges, the proposed structure of the TO commodity charge and Transco's proposed use of PC 77 as the primary way of dealing with over-recoveries.