Pricing Consultation Paper PC78

NTS TO Commodity Charge
(NTS TO Revenue Under Recovery)

1. Introduction

In PC75[1] and PC77[2] Transco proposed the introduction of an NTS TO commodity charge as a means to deal with potential over and under recovery of NTS TO revenue arising from fluctuations in other NTS TO charges. Following Ofgem's veto of PC75 and PC77, Transco now plans to address the issues of the over and under recovery of NTS TO revenue separately. Having reviewed the recent AMSEC entry capacity auctions, the more pressing issue is the mechanism to deal with under recovery. This consultation paper therefore focuses specifically on the introduction of an NTS TO commodity charge as a mechanism for dealing with the under recovery of NTS TO revenue, building on the previous consultation processes.

The most significant concerns expressed in relation to the NTS TO commodity charge, as proposed in PC77, related to issues surrounding over recovery of NTS TO revenue. It is Transco's intention to further consider the implications of Ofgem's decision in relation to over recovery of NTS TO revenue, and this may result in a further consultation paper at a later date to address potential over recovery. However, given the February 2004 AMSEC auction results, development of tools to address any potential NTS TO revenue over recovery will not need to be in place until 2005/06 at the earliest.

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[3] 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.

At present, the flexibility for adjustments to other transportation charges in response to a forecast under recovery from target levels of entry capacity auction revenue 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. Transco would continue to set NTS exit capacity charges with a view to recovering 50% of target NTS TO revenue. Taking account of entry capacity auction revenues, if the NTS TO revenue forecast were in line with, or greater than, the target for total NTS TO revenue then the NTS TO commodity charge would be zero. If the forecast NTS TO revenue were under the target level, then the NTS TO commodity charge could be adjusted accordingly.

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[1] PC75 NTS TO Commodity Charge July 2002
[2] PC77 NTS TO Commodity Charge July 2003
[3] PD17 Setting of NTS Transportation Charges (January 2003).

Transco would publish changes to the NTS TO commodity charge annually in respect of the 12 months commencing each October, unless exceptional circumstances dictate otherwise (this is discussed further under section 6). This process would fit well with the Annual Monthly System Entry Capacity (AMSEC)[4] auction timetable, giving time for Transco to assess the revenue position prior to giving 150 days notice of its intentions in May, consistent with its GT Licence obligation. Two months notice of the revised charge would be provided to shippers, in accordance with the Network Code, by 1st August. Depending on the circumstances, it may be sensible for the NTS TO commodity charge to apply until 31st March and then revert to zero from 1st April. If Transco intends to do this, this will be notified at the same time as the previous October revision is confirmed.

For the avoidance of doubt, this proposal does not deal with NTS TO revenue that is forecast to be above the target level. In a situation where over recovery results from entry capacity auctions then PC65[5] remains the primary TO revenue adjustment tool available to Transco. Clearly, as a mechanism for dealing with under recovery the NTS TO commodity charge would only be positive.

4. Discussion

Issues with adjustments to NTS exit capacity charges

Without an NTS TO commodity charge, Transco's only tool for balancing NTS TO revenue, in a forecast under recovery situation, would be to adjust NTS exit capacity charges. Several concerns have been expressed regarding the use of exit capacity charges for this purpose.

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

Second, 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 clear and stable locational exit capacity signals, particularly given the extent of the changes that might be required.

Third, 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. Adjustments to NTS exit charges for NTS TO revenue balancing purposes would have unintended consequences in relation to Transco's performance against this incentive scheme.

The introduction of an NTS TO commodity charge would avoid the above problems in respect of any forecast under recovery of revenue against the target level. The charge would be a more appropriate mechanism for the adjustment of revenues since it would apply to all firm and interruptible gas flows (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 NTS 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.

Transportation Charge Stability and Predictability

PD17 raised a number of issues associated with charge-setting, including the possible introduction of an NTS TO commodity charge. The majority of the respondents to PD17 who commented on this possibility were supportive of it, for many of the reasons discussed within this paper. 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.

[4] Annual Monthly System Entry Capacity auction held in February of each year.
[5] PC65 Alternative Method of Funding Entry Capacity Constraint Management - July 2001, as amended by PC67 Technical Adjustment to PC65 Mechanism - September 2001.

The uncertainty associated with future charges is driven to a large degree by the entry capacity auction process. As explained above, an NTS TO commodity charge, which would be clearly established as the mechanism for adjusting revenue in the event of a forecast NTS TO revenue under recovery, would be beneficial in improving the stability of NTS exit capacity charges. Furthermore, our proposed approach to the operation of the NTS TO commodity charge, as described in Section 6, would have considerable benefits in relation to charging predictability. We believe that this is consistent with our Licence objective of facilitating effective competition between gas shippers and between gas suppliers.

5. Implementation issues and relationship with other charges and mechanisms

Charging base

It is proposed that the NTS TO commodity charge would be applied on an identical basis to the NTS SO commodity charge. Issues associated with the appropriate charging base for the NTS SO commodity charge have been the subject of recent consultation processes, and apply equally to the proposed NTS TO commodity charge. At present, the NTS SO commodity charge is levied on exit flows only. Following Ofgem's direction in relation to Mod 626[6], the NTS SO commodity charge will from 1st October 2004 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).

In its consultation on PC77, Transco received five responses in favour of applying the proposed NTS TO commodity charge across both entry and exit flows. Four respondents supported the use of entry flows only. Transco accepts that there are arguments for each of these approaches. However, since the purpose of this charge relates to revenue adjustment rather than to provide a signal in relation to particular costs, we do not believe that there is an overriding argument either way from the perspective of cost reflectivity. Given this, our view is that there is considerable merit in mirroring the structure of the NTS SO commodity. This will involve least change in business processes and minimise, for both Transco and shippers, I.T. costs associated with a separate NTS TO charging mechanism.

Transco welcomes further comment from interested parties on whether the charge should be levied on a split between exit and entry flows, fully on either exit or entry flows, or applied to any alternative charging base.

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 NTS TO and NTS 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 an NTS TO commodity charge that can be applied on an identical basis to the NTS SO commodity charge.

All but one of the 7 respondents on this issue within PC77 were in support of retaining an optional NTS commodity charge, and that this should be available as an alternative to a combined NTS SO and TO commodity charge.

[6] Network Code Modification Proposal 0626: Structure of the NTS SO Commodity Charge, direction to implement July 2003.

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

General approach

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. The NTS TO commodity charge will be set to have a zero rate where forecast NTS TO revenue is in line with, or greater than, target revenue.

Following the AMSEC auctions, we would review the forecast revenue position and, if necessary in order to avoid a material under-recovery, we would consider the appropriate adjustment required to the NTS TO commodity charge.

Transco would publish changes to the NTS TO commodity charge annually in respect of the 12 months commencing each October, unless exceptional circumstances dictate otherwise. This process would fit well with the Annual Monthly System Entry Capacity (AMSEC) auction timetable, giving time for Transco to assess the revenue position prior to giving 150 days notice of its intentions in May, consistent with its GT Licence obligation. Two months notice of the revised charge would be provided to shippers, in accordance with the Network Code, by 1st August. Depending on the circumstances, it may be sensible for the TO commodity charge to apply until 31st March and then revert to zero from 1st April. If Transco intends to do this, this will be notified at the same time as the previous October revision is confirmed.

Transco understands that many shippers would favour October as the date upon which charge adjustments should take effect. For Transco to depart from the process outlined above, the level of forecast under-recovery would have to be so great that an earlier (than October) adjustment to the TO commodity charge was preferable in order to limit the level of charge required. Transco would only consider this if the entry capacity revenue were forecast to be more than 30% below target. From auction results to date, we know that this will not be the case in either 2004/05 or 2005/06. We would, however, welcome views on the trade-off between the timing of the adjustment to the TO commodity charge and the level of the charge, in circumstances where auction revenues are very significantly below target. To inform this, at present target entry capacity revenue is around £200m per annum. A TO commodity charge seeking to recover £60m (30% of £200m) between October and March would be of the order of 0.0042 p/kWh if split between entry and exit flows (or 0.0084 p/kWh if levied on exit flows only).

Initial implementation

Transco proposes to implement the charge with effect from 1st October 2004. Two respondents to PC77 noted that implementation of the proposed TO commodity charge should be aligned with structural changes planned to the NTS SO commodity charge, and scheduled for implementation in October 2004.

Following the outcome of the AMSEC entry capacity auction held within February 2004, Transco would expect to establish a positive rate for the proposed TO commodity charge to apply from October 2004.

7. Summary & Questions for Consultation

This paper has set out our proposal for the introduction of a NTS TO commodity charge, implementation of this charge, to be used to balance revenue in the event of an under recovery, would remove the prospect of potentially distortionary adjustments to NTS exit capacity charges. This would ensure NTS exit charging provides stable locational signals and avoids unintended consequences in relation to Transco's performance against the incremental exit capacity incentive scheme. We believe this proposal is consistent with the relevant objectives in our GT licence to ensure that charges reflect the costs we incur in our transportation business and that the charging methodology properly takes account of development within the transportation business.

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 from October 2004, additional to the NTS SO commodity charge, which would be used to adjust the level of NTS TO revenue if there is forecast to be material under-recovery of NTS TO revenue against the maximum allowed NTS TO revenue following the AMSEC auctions;
- That the NTS TO commodity charge will be set to have a zero rate where forecast NTS TO revenue is in line with, or greater than, target revenue;
- That the NTS TO commodity charge should have an identical structure at all times to the NTS SO commodity charge;
- That the NTS TO commodity charge will be the mechanism for adjusting any forecast NTS TO revenue under recovery against NTS TO maximum allowed revenue;
- That the Optional NTS SO Commodity Tariff remains available, as an alternative to the combined NTS SO and NTS TO commodity charge.

In particular we would be pleased to receive views on the following two issues that were discussed within the paper:

- Whether the proposed TO commodity charge should be levied on a split between exit and entry flows, fully on either exit or entry flows, or applied to any alternative charging base;
- The trade-off between the timing of the adjustment to the TO commodity charge and the level of the charge, in circumstances where auction revenues are very significantly below target i.e. is a higher charge to a strict timetable preferred to a lower charge on a more flexible timetable.