

## TRANSCO PRICING DISCUSSION PAPER PD13

### NTS Auction Over-Recovery

#### SUMMARY

Transco at present makes monthly volumes of System Entry Capacity available for allocation by auction. If auction revenue is considerably over or under target revenue - the level that would have been raised with administered charges - Transco's Transportation Charging Methodology provides for a countervailing adjustment to be made to the NTS commodity charge. When auction results imply revenue above the administered level, however, the charging methodology specifies a minimum level for the NTS commodity charge.

As a result of accepted bids in the auctions for April to September 2001 Monthly System Entry Capacity (MSEC), Transco has given notice that the NTS commodity charge applicable from 1 April 2001 will be reduced to the minimum level specified by the charging methodology, 0.0022 pence per kWh. Revenue over the period will, however, remain in excess of the administered level. This discussion paper therefore invites views on whether Transco's Transportation Charging Methodology should be modified in order to deal with the present position and any future recurrence. Eight main options are described:

1. To carry forward the excess revenue to the following period for which NTS capacity is auctioned, such that the NTS commodity charge in that period reflects the outcome of previous NTS capacity auctions;
2. Reducing NTS exit capacity charges in addition to the commodity charge.
3. Using excess revenue to fund any costs otherwise incurred by both Transco and Users if and when it proves necessary for Transco to buy-back entry capacity;
4. Introduction of an entry based commodity rebate, based on UDQIs;
5. Creation of an investment fund which could be used to fund capacity enhancing projects;
6. Scaling accepted bids;
7. Maintaining the present charging methodology, whereby any over- or under-recovery of transportation charges relative to the price control formula is reflected in the adjustment factor, K, with the level of transportation charges adjusted accordingly; and
8. A flat rate rebate based on throughput, capacity or customer numbers.

In view of the significant over-recovery in the present round of MSEC auctions, Transco would also welcome views on the appropriate timing of any change to its Transportation Charging Methodology.

## 1. INTRODUCTION

Monthly System Entry Capacity auction revenue has generally exceeded the level implied by administered charges. As a result, post-auction adjustments have been made to the level of transportation charges. The Transportation Charging Methodology provides for the NTS commodity charge to be adjusted in the light of auction revenue. Any further variation in revenue relative to that set by the price control formula is dealt with through the standard mechanism for carrying forward any under- or over-recovery relative to the price control level - the K mechanism.

The most recent set of monthly capacity auctions (April to September 2001) has resulted in a level of income that is such that the present Transportation Charging Methodology will result in a large portion of the deviation from target revenue, over £300m, remaining to be dealt with through a general charge reduction. Given that the present charging methodology includes arrangements designed to avoid this outcome, Transco believes that interested parties should be given an opportunity to express views on a number of possible changes to the Transportation Charging Methodology.

## 2. NTS BASED OPTIONS

When Transco's Transportation Charging Methodology was modified such that the NTS Commodity rate would be adjusted in the light of auction outcomes, this reflected a view that any variations should be focussed on NTS charges. This in turn reflected concerns that to do otherwise could be regarded as leading to less cost-reflective LDZ charges for LDZ loads which might be regarded as unduly discriminatory. It is also consistent with the proposal to implement separate NTS and LDZ price controls from April 2002.

A number of possible approaches could be adopted which would focus adjustments on NTS charges.

### 2.1. Carry Excess Revenue Forward

One option would involve carrying forward the excess revenue to the following period for which NTS capacity is auctioned, such that the NTS commodity charge in that period reflects the outcome of previous NTS capacity auctions.

Some key issues raised by this approach are:

**Distributional Impacts:** This approach would ring fence revenue adjustments within the NTS tier and hence potentially reduce some distributional impacts. However, system usage follows a seasonal pattern with differing patterns followed by various categories of customer. Carry-over of excess revenue from one six monthly auction period to the next could therefore have distributional effects between both shippers and individual gas consumers.

**Sustainability:** The level of over recovery that has resulted from the most recent set of auctions is such that the necessary carry over could not be fully returned by a NTS commodity charge adjustment during the next auction period - in the absence of significant under-recovery in the next round of auctions.

**Licence Obligations:** Carrying forward over-recovery may be inconsistent with Transco's Licence obligation to take all reasonable steps to avoid recovering more than permitted by the price control formula in any year.

The unpredictability of future auction results makes it difficult to ascertain whether or not this approach can offer a viable long-term solution. But it does not offer a full solution in the short term and would need to be accompanied by other charge reductions in the present formula year if Transco is to avoid over-recovery.

## 2.2. Reduce NTS Exit Charges

Given that reducing the NTS Commodity Charge cannot offer a full solution in all circumstances, one option would be to also reduce NTS Exit charges.

Some key issues raised by this approach are:

**Distributional Impacts:** As with reducing the commodity charge, this approach would ring fence revenue adjustments within the NTS tier and hence potentially reduce some distributional impacts. However, the impact would also vary significantly between interruptible and firm loads, since interruptible loads do not attract exit charges at present.

**Sustainability:** The level of over-recovery that has resulted from the most recent set of auctions is such that the excess would be fully returned only by reducing exit charges to zero, in addition to reducing the NTS commodity charge to its minimum level, for the whole of the forthcoming formula year. This assumes that there is no significant under- or over-recovery in the next round of NTS auctions.

As with the commodity charge reduction, the unpredictability of future auction results makes it difficult to ascertain whether or not this approach can offer a viable long-term solution.

## 2.3. Fund Capacity Buy Backs

If on a daily basis Transco is unable to meet Shipper's demand to use entry capacity entitlements, it must buy back capacity. Transco is liable for 20% of the cost, with the other 80% being met by the shipper community on a non-terminal specific basis. There is, however, a monthly cap on Transco's liability, beyond which the shipper community accounts for 100% of the cost.

It has been suggested that excess revenue from NTS auctions could be used to fund the costs otherwise incurred by both Transco and Users if and when it proves necessary for Transco to buy back entry capacity.

Some key issues raised by this approach are:

**Licence Issues:** Transco's PGT Licence would need to be modified to accommodate this approach. Any such changes to the Licence would require a process separate from any change to the Transportation Charging Methodology.

**Sustainability:** If this mechanism were adopted, the level of buy back costs may be higher or lower than the excess revenue from auctions which was available to fund buy backs. In the event of an excess, a separate mechanism may be required to ensure Transco does not retain revenue in excess of the maximum allowed by the price control formula.

**Distributional Impacts:** Any scheme to inter-relate the post-auction adjustment and incentive mechanism will introduce new distributional effects which will depend on shippers' commercial positions in each area. Any temporal gap between possible adjustments may itself lead to distributional impacts as shipper portfolios change.

#### 2.4. Entry Commodity Rebate

A new negative transportation charge could be created based on User Daily Quantity Inputs (UDQIs) with a rebate paid on volumes of gas input into the Transco network at each Aggregate System Entry Point (ASEP).

Some key issues raised by this approach are:

**Auction Rationale:** The creation of a UDQI based rebate may be regarded as being similar to an approach that involved scaling accepted bids by an absolute amount, since it would tend to return revenue to those that had bids accepted. This approach could therefore raise the same questions as bid scaling with regard to the basic rationale behind allocation of a scarce resource by means of an auction (see below).

**Implementation:** Rebates based on UDQIs would take time to develop because of the need to establish clear business rules and implement appropriate systems. Hence any payments under this mechanism would necessarily be delayed. No existing transportation charges are based on this item and a new charge category would need to be developed, with consequences for invoice production. Creating a negative transportation charge, may also cause conflicts with elements of the Network Code and the price control description in Condition 9C of Transco's PGT Licence. It may, for example, be necessary to amend the PGT Licence in order for any such rebate to be accounted for as negative income within the price control formula, and this could further delay any implementation date.

#### 2.5. Creation of An Investment Fund

It would be possible for over-recovery in excess of the amount that can be returned through adjustment of the NTS commodity charge to be allocated to an "investment fund". This could then be used as a means of funding capacity enhancing investments.

Such investments could be seen as a means of providing capacity beyond the level which Transco provides to meet its Licence obligations. Since the investment would be fully funded, there would be no net investment to be included within Transco's Regulatory Asset Base and so no addition to future transportation charges - apart from funding ongoing maintenance and, in due course, replacement.

Some key issues raised by this approach are:

**Licence Issues:** The PGT Licence would need to be amended such that the revenue would fall outside the price control.

**Implementation Details:** Issues would need to be addresses about how decisions should be taken as to which investments should be undertaken and the way in which any additional capacity were made available. It may be appropriate for Transco to be incentivised to invest efficiently rather than being required to spend a fixed amount, with Transco retaining part of the fund if outputs were delivered for lower cost than anticipated.

**Timing:** Since NTS investment generally requires long lead times, the investment fund would not be used immediately. In addition, investment costs are unlikely to exactly equal the amount available in any fund. Issues would therefore need to be addressed about how funds were treated prior to use, and how any excess should be treated.

**Future Treatment:** The regime for future NTS investment would need to be considered such that the linkages between investment funded through different routes was clear. For example, if incremental capacity were provided beyond Transco's obligations, should this be a permanent or transitory increment?

## 2.6. Scaling of Accepted Bids

Under this approach, accepted auction bids could be scaled downwards. Scaling could be carried out on either a percentage or absolute value basis, with the level either being terminal or non terminal specific. Scaling could also be limited such that the price paid for capacity at any terminal did not fall below the reserve price.

Some key issues raised by this approach are:

**Auction Rationale:** Focussing any adjustment as a result of auction related revenue variation on the auctioned transportation service itself might be considered desirable since it would be targeted on the area where the revenue difference arose. It offers, therefore, the potential to neutralise any undesired or unanticipated effects from the auctions. However, this strength may also be considered the key weakness of the approach since it may not only neutralise undesired impacts, but may also neutralise the beneficial impacts which auctions have been introduced to deliver. Any break in the link between the bid price and the price paid could risk creating auctions which are less efficient means of allocating a finite resource. In extremis, the approach could amount to constraining prices paid to a pre-determined level and a return to administered charges.

If this approach were adopted in the current circumstances, with the NTS Commodity rate remaining at its minimum level and charges at least equal to the reserve price, auction prices would need to be scaled by about 75%.

### 3 SYSTEM WIDE OPTIONS

Rather than restrict any adjustment to the NTS charging tier, the potential over-recovery could be avoided at a system wide level. Two options are described below.

#### 3.1 Maintain the Present Methodology

The first, and default, option is maintaining the present charging methodology, whereby any over- or under-recovery of transportation charges relative to the price control formula is reflected in the general level of transportation charges. In the absence of any change to the Transportation Charging Methodology, this is the approach Transco would expect to take to any potential over-recovery as a result of auctions, with any reduction subject to the two month notice period specified in the Network Code.

Some key issues raised by this approach are:

**Cost Reflectivity:** Adjustments to the general level of transportation charges in order to compensate for revenue variation within a particular tier may be regarded as representing an undue cross-subsidy. This is a particular issue with regard to the NTS auctions, since the bulk of any general adjustment would be accounted for in non-NTS charges.

**Price Stability:** Adjustments to the general level of charges to offset auction revenue clearly leads to price instability. In addition, adjustments for revenue deviation in one period are not necessarily made to cover the same period. Therefore there could be a mismatch in the pattern of usage between the period in which a deviation from target revenue occurred and the period in which countervailing action was taken. This may further increase price instability.

**Cash Flow:** Relying on the standard mechanism to return excess revenue is likely to lead to cash flow benefits for Transco to the extent that the revenue adjustment applies to a period beyond that to which the auction applies.

This approach may be regarded as more acceptable when applied to relatively minor auction related revenue deviations. However the present situation is such that this mechanism would be employed to remove a relatively large deviation. It would, for example, imply a reduction of some 37% in all major transportation charges if the excess revenue were to be returned in the period April to September 2001 - the period for which capacity was auctioned. If spread across the period to April 2001 to March 2002 - consistent with the year to which Transco's price control formula applies - the reduction would be of the order of 13%.

### 3.2. One-Off Adjustment

The present over recovery may be regarded as reflecting the underlying value placed on entry capacity in the present market conditions. To avoid distorting this market outcome, a non-distortionary mechanism for returning the excess revenue may be regarded as economically efficient. This suggests that it may be appropriate for Transco to pay one-off rebates based on a fixed, historic, system wide factor. This might take the form of a one-off reduction in the aggregate amount of transportation charges due from each Shipper. Such a reduction could, for example, be based on shares of a snapshot of AQ (representing throughput), SOQ (representing capacity), or supply points (representing customers).

Some key issues raised by this approach are:

**Distributional Effects:** While a one-off rebate could be regarded as non-distortionary, the impact on particular shippers and customer groups could be significant and may be regarded as unduly discriminatory.

**Implementation:** Any form of rebate may take time to develop because of the need to establish clear business rules and implement appropriate systems. Hence any payments under this mechanism would necessarily be delayed. Creating a negative transportation charge, may also cause conflicts with elements of the Network Code and the price control description in Condition 9C of Transco's PGT Licence. It may, for example, be necessary to amend the PGT Licence in order for any such rebate to be accounted for as negative income within the price control formula, and this could further delay any implementation date.

**Sustainability:** While a one-off adjustment may offer a potential solution to the present position, it may not offer a longer term solution should a similar situation arise in future.

## 4. CONCLUSION

The level of bids in the most recent set of NTS capacity auctions implies a level of revenue which, in the absence of a change to transportation charges, would lead to Transco recovering substantially more than the maximum permitted under its price control in the forthcoming formula year. The existing Transportation Charging Methodology allows for this to be corrected through a general reduction in transportation charges at some stage. Transco recognises, however, that the scale of any such adjustment would be significant, and there are options regarding the timing of any such adjustment. In addition, alternative approaches may be desirable in light of the auction results.

This paper therefore sets out a number of possible options. Transco would welcome views from interested parties on each of the options explored above, and would also welcome other suggestions as to how best to deal with the mismatch between auction and price control revenues. In view of the scale of over-recovery generated by the recent auctions, Transco would also welcome views on the timing of any potential

change to the either the level of transportation charges or the Transportation Charging Methodology.

In light of comments received, Transco will develop a proposed way forward and, if necessary, issue for consultation any potential change to the Transportation Charging methodology. The PGT Licence effectively requires a five month period before any change to the Transportation Charging Methodology can be implemented. If respondents support a change to the Transportation Charging methodology, Transco would expect to seek a derogation from this timetable in order to facilitate early implementation. Similarly it would be necessary for the Network Code to be modified if the level of transportation charges was to be amended with less than two months notice of implementation.

**In view of the timetable constraints, early comments would be appreciated and replies by 16 March 2001 are requested.**