Pricing Discussion Paper PD19

NTS TO and SO Exit Commodity Charging

1. Introduction

The proposed reform of NTS exit arrangements expected in October 2008 would change the way in which NTS TO (Transportation Owner) exit revenue is recovered. Making NTS exit flat capacity and the new NTS exit flexibility capacity product available through auction mechanisms would have implications for how Transco ensures its actual TO revenue is recovered in line with its allowable revenue and associated licence conditions. Exit reform would also bring change in respect of which parties are responsible for securing NTS exit flat capacity and exit flexibility capacity. It is appropriate to consider what changes, in light of NTS exit reform, are required to the transportation charging methodology to ensure the appropriate recovery of Transco's allowable revenue.

This pricing discussion paper explores issues related to NTS TO revenue balancing and also considers what, if any, consequential changes are required to the current NTS SO (System Operator) exit commodity charge.

It is not the intent of this discussion paper to address issues beyond those clearly needed in support of NTS exit reform.

A number of other transportation charging methodology modifications may be required to NTS transportation charges. These issues are discussed in related papers numbered PD18[1] and PD20[2], both of which have a bearing on this pricing consultation. Respondents are therefore requested to review this document in the context of wider transportation charging methodology change discussion.

It is envisaged that change to the charging structure, if necessary, would be required from October 2008. If Transco intends to bring forward change to its transportation charging methodology in respect of NTS transportation charges, it would raise a proposal and consult formally with the industry.

2. Licence Requirements

The Transmission Licence requires Transco to propose changes to the charging methodology where the resultant charges would achieve the relevant objectives. The relevant objectives are namely that charges calculated in accordance with the methodology should:

1. Reflect the costs incurred by the licensee in its transportation business
2. So far as is consistent with (1) properly take account of developments in the transportation business
3. So far as is consistent with (1) and (2) facilitate effective competition between gas shippers and between gas suppliers.

Where prices are established by auction the first objective is replaced by the requirement that reserve prices, if used, should be set at levels best calculated to promote efficiency and avoid undue preference in the supply of transportation services and promote competition.

[1] PD18 NTS Exit Flat Capacity Pricing – March 2005.
[2] PD20 NTS Exit Flexible Capacity and Commodity Charges – March 2005.

With the development of Exit Reform and Network Sales, Transco is required by these conditions to consider what changes to the charging methodology are required. Any proposals must be shown to be cost reflective, and as far as is consistent with the other relevant objectives, facilitate competition.

Transco notes that Gas Transporter licence arrangements are currently being discussed with the industry as a consequence of changes required to facilitate Network Sales and NTS Exit Reform. As part of this process, Ofgem has proposed a further charging licence obligation on NTS and DN licensees which may restrict the frequency and date upon which charges may be changed by a licensee within any formula year.

In addition to the licence conditions governing the charging arrangements, Transco has licence obligations to use best endeavours to ensure that in setting charges, the revenue derived from the SO and TO activities does not exceed the maximum allowed.

The licence allows for the fact that actual revenue in any year will not precisely equal the maximum allowed. If there is over-recovery (collected income exceeds the maximum allowed revenue), then this plus interest (together known as "K") is subtracted from the maximum allowed revenue in the following year, and vice-versa for under-recovery. However, the interest adjustment on over-recoveries (reducing the maximum allowable revenue) is base rate plus 3% whereas on under-recoveries it is base rate. The licence obligation not to over recover, reinforced by the financial incentives in the form of the imbalance in the level of interest adjustment, requires Transco to consider making transportation charge adjustments if there is a possibility of over-recovery occurring in either business area.

3. Recovery of TO Allowable Revenue

Transco aims to recover all NTS TO allowable revenue through the application of capacity charges at NTS entry and exit. This is consistent with TO costs being principally linked through our NTS TO price control to the provision of entry and exit capacity. We have previously discussed with the industry the balance of costs associated with providing NTS entry/exit capacity, and how this balance can change over time[3]. In the interests of reducing charge volatility and issues of entry/exit equitability, Transco has from April 2002 aimed initially to recover 50% of NTS TO revenue from NTS entry capacity charges with the remaining revenue recovered from NTS exit charges. In practice, other tools are required where revenue targeted for recovery through market-based mechanisms may not be consistent with Transco's forecast revenue target levels. Additionally, in the interests of cost reflectivity, Transco does not currently scale auction reserve prices to match the entry revenue target level.

3.1 Present NTS TO Exit Charges

Currently, NTS TO exit revenue is principally recovered through the application of administered NTS exit capacity charges levied on shippers' levels of registered NTS firm exit capacity. These charges are set at a level to reflect our analysis of the long run marginal cost (LRMC) of reinforcing the NTS for an increment of flow as described within our transportation charging methodology statement. Additionally, prior to NTS exit reform being implemented, Transco's licence requires that an amount of TO revenue be recovered through SO charges to represent that revenue that would otherwise have come from charges that shipper interruptible customers may have paid, had they been connected to Transco's system on a firm transportation basis.

At present we have the flexibility to amend NTS exit capacity charges in order to recover the appropriate proportion of our revenue allowed by our NTS TO price control (i.e. 50%). If auctions are introduced for NTS exit capacity, we will lose this flexibility.

[3] PC71 NTS Transmission Asset Owner Charges - November 2001

3.2 Present NTS TO Entry Charges

Currently, NTS TO entry revenue is recovered principally from entry capacity charges levied on capacity allocated to shippers through (and at the prices determined by) entry capacity auctions. Transco bases its auction reserve prices, the minimum price that shippers must bid for a unit (kWh) of entry capacity, on Unit Cost Allowances (UCAs) set by Ofgem and contained within our Gas Transporter licence. In its submission to Ofgem for the purposes of setting UCAs, Transco provides cost data based on similar analysis undertaken for the setting of NTS administered exit capacity charges i.e. the LRMC of reinforcing the NTS for a given increment of flow.

Where revenue is recovered from charges levied on the output of auctions, both the demand and price that shippers bid for the capacity product will dictate whether actual revenue is less than or greater than Transco's revenue target. As noted above, Transco bases it auction reserve prices on Ofgem determined UCAs, and these values are intended to provide a locational investment signal for providing a given increment of flow. In the interest of cost reflectivity, these reserve prices are not scaled to ensure actual revenue meets the target level.

Following several pricing consultation and discussion papers, a TO entry commodity charge was introduced. This is used where the revenue from NTS entry auctions is less than the appropriate portion (50%) of our maximum allowed NTS TO revenue.

3.3 NTS TO Revenue Implications of NTS Exit Reform

Issues with balancing NTS TO revenue

Transco is developing proposals to reform the NTS exit regime to make NTS exit flat capacity and a new NTS exit flexibility capacity product available through auction mechanisms that are broadly similar to its existing NTS entry capacity regime. It is anticipated that these NTS exit products would be acquired by shippers for NTS direct connects and by Distribution Network Operators (DNOs) for Distribution Networks (DNs), with charges being determined through the auction processes.

Our initial thoughts are that, notwithstanding the proposed reforms, we would continue to seek to recover 50% of the NTS TO revenue from entry charges with exit charges recovering the remainder. Charges levied in respect of the proposed NTS exit flat capacity product and NTS exit flexibility capacity product would contribute to TO exit revenue.

Since revenues arising from auctions are intrinsically unpredictable, a new charge would be required in order to allow Transco to ensure that its total revenue is consistent with that allowed by its price control.

We believe that it would be appropriate to have a common approach at exit to that in place at entry. The use of a TO commodity charge was debated with the industry at great length prior to its implementation for NTS entry flows. An exit TO commodity charge could be used where TO revenue is forecast to be less than (positive charge) or greater than (negative charge) the exit revenue target level. Industry views are invited on the use of an NTS TO exit commodity charge for this purpose once exit auctions become the principal source of NTS TO exit revenue.

Charging Base

From October 2008, it is expected that NTS exit flat capacity and NTS exit flexibility capacity would be acquired by, and charged to, shippers for NTS directly connected sites and DNOs for DNs. This raises an important question as to whether an NTS TO exit commodity charge should, in common with capacity, be levied on both shippers and DNs as appropriate or whether, as now, commodity charges should continue to be levied solely on shippers.

Transco recognises that an important part of the entry TO commodity debate within recent years has focused on which party should pay the charge. We consulted on this issue within PC78[4], and asked

[4] PC78 – NTS TO Commodity Charge (NTS TO Revenue Under-Recovery) - June 2004

for views on whether a positive entry TO commodity charge should be split equally between entry and exit users or levied solely on entry or exit users. Understandably, given the differing interests of respondents, there was no industry consensus on this issue. However, Transco agreed, on balance, with those respondents that argued the TO entry commodity charge should be levied on entry flows to maintain the TO entry / exit revenue split and target those users that have the potential to give rise to any under-recovery of revenue. A consistent approach at NTS exit may suggest any TO exit commodity charge should be levied on both shippers (for direct connects) and DNO exit flows at their respective NTS interface.

Notwithstanding the above, Transco recognises that the form of the DNO licence incentive arrangements has not yet been finalised and will be the subject of a consultation process by Ofgem. In this context, we would be interested in respondents views on the relative benefits of levying any element of an NTS TO exit commodity charge on DNOs, as opposed to solely on shippers. The extent to which such costs may, or may not, be the subject of DNO pass through to shippers will be a matter for the DN licences.

Dependent on the discussion above, a further point to consider in application of any NTS TO exit commodity charge, is whether forecast revenue variances should be considered separately for tariff setting purposes at NTS exit and NTS entry, respectively, or whether a combined tariff is appropriate. For example, if TO exit revenue recovery were forecast to be above the exit target level, and TO entry revenue recovery forecast to be symmetrically under the entry target level, then should adjustments be made to separate TO exit and entry commodity charges or would it be more appropriate to have a combined entry and exit commodity charge such that in such circumstances, changes to the TO commodity charge would not be required.

4. Recovery of SO Allowable Revenue

4.1 Present NTS SO Charges

The NTS SO commodity charge recovers SO allowable revenue in accordance with Transco's NTS SO price control. This SO allowable revenue, net of forecast revenue arising from charges for St Fergus compression and the optional NTS commodity charge, is, from 1 October 2004[5], recovered from a common tariff levied on shipper NTS entry and exit flows. Prior to this date, the NTS SO commodity charge was levied solely on shipper NTS exit flows.

4.2 Interactions with NTS Exit Reform

<u>Issues with the NTS SO commodity charging base</u>

In common with the discussion within Section 3.3 of this paper, it may be appropriate to reflect developments within the transportation business and consider whether the exit component of the NTS SO commodity charge should be levied solely on shippers or split between shippers for NTS direct connects and DNOs for DN exit flows from the NTS.

The NTS SO commodity charge recovers NTS SO allowable revenue as defined within Transco's transportation licence[6]. These costs reflect a number of different incentive components, many of which are applicable to both shippers and DNO's. There are therefore comparable arguments on the grounds of cost reflectivity to levy the SO commodity charge at exit on either shippers or DNOs (and directly connected shippers). However, charging NTS SO exit commodity to DNO's could deliver a common transportation charging base for NTS exit charging at the DN interface with clear responsibility being established for the recovery of NTS exit transportation costs by a single party within each distribution network. Charging DNOs would also be consistent with existing arrangements in that both the SO and TO commodity charges are levied on those parties responsible for acquiring NTS capacity.

[5] As brought about by PC73 Structure of the NTS SO Commodity Charge – April 2002, and the Network Code as modified by Network Code Modification Proposal 0626 "Structure of the NTS SO Commodity Charge" – April 2003
[6] Transco's Gas Transporter licence Special Condition 28B.

From a practical perspective, levying any commodity charge on shipper exit flows would require the provision of data from each DNO for each DN supply point. No such data flows would be required for commodity charges levied on flows at each NTS offtake point.

The NTS SO commodity charge is payable on both entry and exit flows. The net target revenue to be recovered by the SO commodity charges would be the total SO allowed revenue less that revenue recovered by the St Fergus compression charge and by the optional commodity charge. This net SO revenue is then recovered equally from NTS entry and exit flows. Dependent on the charging consultation outcome of PD20[7], the net SO exit revenue may be divided further between flow flexibility flows and NTS exit flows.

NTS SO entry commodity would continue to be levied on shipper entry flows at System Entry Points.

In common with the TO exit commodity proposal, Transco invites views on whether the NTS SO commodity charge at exit should continue to be levied solely on shippers, or whether shippers and DNO's should be liable for the charge at their respective NTS interfaces.

5. Possible Changes to NTS Transportation Charging

Transco considers that NTS exit auctions, as proposed by Transco's NTS exit reform, would have implications for the recovery of NTS TO allowed revenue. As discussed in this paper, an additional NTS TO charging mechanism would be required to cover the possibility that primary NTS TO capacity charges do not recover the full NTS TO revenue allowed in Transco's Gas Transporter licence. In such circumstances, Transco invites views on whether a TO commodity charge, as outlined below, is an appropriate method to ensure compliance with our relevant licence obligations.

Additionally, in light of wider developments in the transportation business, it would seem appropriate to consider whether, in common with NTS exit flat capacity and NTS exit flexible capacity products, the NTS exit commodity charging base should be modified with a view to levying NTS exit commodity charges on both shippers and DNOs as appropriate. Such an approach would affect the NTS SO exit commodity charge and, if proposed by Transco and accepted by the Authority, any NTS TO exit commodity charge.

Transco considers that the possible changes described above are consistent with Transco's licence obligation to ensure its charging methodologies properly take into account developments within the gas transportation business and are also consistent with Transco's relevant licence revenue restrictions.

Clearly any NTS TO or SO commodity proposals that may follow from discussion within this paper may have implications for DNO's should Transco NTS propose to levy charges on these parties. It would be for Distribution Network Operators to consider the implications of any proposed NTS charge base and, if they consider it necessary, bring forward transportation charging methodology proposals in due course.

5.1 Possible Requirement for an NTS TO Exit Commodity Charge

A TO exit commodity charge could, from 1 October 2008, be used at exit to address NTS TO revenue over or under-recovery, against the NTS TO exit revenue target level, arising from the proposed NTS exit auctions (NTS exit flat capacity and possibly NTS flexible capacity). This approach would be consistent with Transco's aim to recover 50% of its NTS TO revenue through NTS exit charges, assuming that the other 50% will be recovered through NTS TO entry charges.

Taking account of NTS exit auctions (exit flat capacity and possibly flexible capacity), an NTS TO exit commodity charge may be positive or negative. A positive TO exit commodity charge may arise where NTS TO exit revenue is forecast to be lower than the exit revenue target level. Conversely, a negative TO exit commodity charge may arise where NTS TO exit revenue is forecast to be greater than the exit revenue target level.

[7] PD20 NTS Exit Flexible Capacity and Commodity Charges – March 2005

A TO exit commodity charge would, if proposed, be the sole tool available to Transco for the purpose of balancing NTS TO exit revenue against the exit target level following the outcome of NTS exit auctions (NTS exit capacity and NTS flexible capacity).

As discussed in this paper, an NTS TO exit commodity charge could be levied on NTS exit flows to both shippers in respect of exit flows at directly connected NTS loads and DNO's in respect of exit flows from the NTS into distribution networks. Transco considers this approach to be consistent with recent industry discussion to introduce an NTS TO entry commodity charge, however, we welcome further views in this respect.

Whilst an NTS TO exit commodity charge may be negative, it may be necessary to collar the extent of any negativity. We believe it important that transportation charging should not create a perverse incentive to flow gas, but rather system use be driven by the commercial supply and demand considerations of shippers and consumers. However, we do not consider it necessary that such a test should be undertaken in isolation at entry or exit since, ultimately, the transportation costs borne by customers are a combination of both entry and exit charges. It may therefore be necessary to ensure that the sum of NTS TO and SO commodity charges (excluding the St Fergus compression, NTS optional and possibly[8] NTS flexible commodity charges) at both entry and exit would not be negative. To inform this position, each £10m of NTS TO exit revenue over-recovery may result in an annual TO exit commodity rate, on exit flows, of approximately - 0.001 pence per kWh.

5.2 A Possible Approach to NTS Exit Commodity Charge Application

For charge application purposes, any TO and SO exit commodity charges could be combined and levied as a single NTS commodity charge at exit. Naturally this would only be possible if a common charge base existed between any TO exit commodity charge and the SO exit commodity charge. Common application would involve least change in business processes and minimise, for both gas transporters and shippers, I.T. costs associated with separate NTS TO exit commodity and NTS SO exit commodity charges.

6. Questions for Consultation

Transco is interested in the views of respondents on the issues outlined above and, in particular, from the time where NTS exit regime reform becomes effective:

- Whether an NTS TO exit commodity charge, set in light of auction-derived revenues, would be an appropriate mechanism to ensure Transco can comply with its revenue restriction licence obligations;
- Whether an NTS TO exit commodity charge, if proposed, should be levied on shipper NTS exit flows for their NTS directly connected sites and on DNOs for exit flows at the NTS/DN interface;
- Whether the level of an NTS TO exit commodity charge, if proposed, should be set based solely on NTS exit flows, or whether such a charge should be levied commonly on NTS exit and entry flows taking account of both exit and entry revenue recovery;
- Whether an NTS TO exit commodity charge, if proposed, should be collared to prevent the aggregate of NTS TO and SO commodity charges at both entry and exit from being negative;
- Whether the NTS SO exit commodity charge should, in common with any NTS TO exit commodity charge, be levied on NTS exit flows for shippers and DNO's at there respective NTS interface, or whether the charge should continue to be levied solely on shipper system exit flows.

[8] PD20 NTS Flexible Capacity and Commodity Charges – March 2005

If, following responses to this discussion paper, Transco intends to propose a change to its methodology for setting NTS transportation charges, it will issue a Pricing Consultation paper on the proposed change.

The closing date for submission of your response is **21st April 2005**.

Your response should be e-mailed to craig.maloney@ngtuk.com or alternatively by post to Craig Maloney, Commercial Frameworks, National Grid Transco, NGT House, Gallows Hill, Warwick, CV34 6DA. If you wish to discuss any matter relating to this charging methodology consultation then please call on 01926 656213.

It would be helpful if your response could be copied to Ofgem by post to Sonia Brown, Director – Transportation, Ofgem, 9 Millbank, London, SW1P 3GE or by e-mail to sonia.brown@ofgem.gov.uk.

Responses to this paper will be incorporated either within a Pricing Discussion conclusion report or, if a formal change to the methodology is to be pursued, within the relevant Pricing Consultation paper.

Should you wish your response to be treated as confidential, please mark it clearly to that effect.