

TRANSCO CONSULTATION REPORT ON PC53

NTS Entry Capacity Auction Revenue Re-balancing

1. Transco's Initial Proposal

In PC53 Transco invited views about the issue of how transportation charges should be adjusted in light of the outcome of entry capacity auctions both in the short and longer term. With a focus on the immediate over-recovery situation, Transco sought views on four main options. These were adjusting:

- A. all transportation charges;
- B. the NTS commodity charge;
- C. NTS exit charges; or
- D. NTS entry charges.

If customers supported an early correction of transportation revenue, Transco proposed that the most feasible options would be to make an adjustment through either a reduction in the NTS commodity charge or by scaling successful bids in the recent capacity auctions, potentially with effect from 1 May 2000.

2. Summary

In total there were 31 responses: 26 from shippers or suppliers, 4 from industry groups and one from a gas customer.

From the 31 respondents, 16 supported adjusting entry charges exclusively. 6 expressed a preference for a uniform scaling back of bid prices whilst 9 preferred a terminal specific solution. 1 supported an entry solution but did not express a preference with regard to a redistribution mechanism. 2 respondents supported an adjustment to the NTS commodity charge, 1 supported a rebate based on UDQI, 1 supported an early adjustment to all charges and 1 supported an adjustment through K in October 2000 charges.

5 hybrid solutions were proposed: 1 supported a combination of a rebate through UDQI and the NTS commodity charge, 1 offered support for adjusting entry charges and for a rebate through UDQI, 1 supported an entry/exit solution and 2 supported adjusting the NTS commodity charge and entry charges. 5 respondents did not support any of the options proposed in PC53 and suggested alternatives.

3. Option A - Adjusting all Transportation Charges

2 respondents supported an adjustment to all transportation charges, 1 through K and 1 for the period covered by the MSEC auctions.

1 respondent viewed K as an appropriate mechanism because it is the established method for reapportioning transportation revenue, having precedence in terms of Transco's PGT Licence and from its agreed application in redistributing income from the system tolerance service. In their view, using K to redistribute the MSEC over-recovery would lead to market stability and could discourage aggressive bidding in future auctions. Another respondent found it difficult to understand why an early adjustment to all transportation charges should not be implemented on the grounds that it will potentially create price instability. They noted that increased transportation charges in October 2000 would be expected if this option were implemented which the industry could plan for.

This option was opposed by other respondents. The main arguments against it were that it would be unnecessarily complex, would discriminate against certain market sectors due to its distributional impacts, could lead to price instability and would not target costs effectively. Some respondents thought that to return revenues through K would leave the market with an expectation of continuing high capacity prices, which may have a knock-on effect in the next set of auctions and that the K mechanism did not envisage the present level of over-recovery. It was also argued by one respondent that reductions in transportation prices at any time other than October each year generally represent an unexpected margin gain for downstream shippers and that for most consumers, these lower costs for suppliers are not translated into reduced prices.

Transco's Response

Whilst K is the established mechanism for the redistribution of over-recovery against allowed revenue, it is Transco's view that developments in the gas transportation business, such as the NGTA, can create new requirements which should arguably be addressed by changes to Transco's transportation charging methodology.

Although the potential need for revenue adjustments was one of the issues discussed during the RGTA process, respondents have generally expressed concerns that reliance on K would not be appropriate in the present circumstances, and that such an approach would lead to market distortions, away from cost-reflectivity, and could create price instability which the majority of respondents viewed as an undesirable consequence.

Given that the weight of opinion from respondents is not in support of this option, Transco does not propose that the present over-recovery be returned to the market by means of an early adjustment to all transportation charges. However, Transco believes that, where the over (or under) recovery against allowed revenues is modest, adjustment of prices through K at the normal time for price changes is the most appropriate way forward.

4. Option B - Adjusting NTS Commodity Charge

This option was supported exclusively by 2 respondents and as part of a hybrid solution by 2 other respondents.

One respondent considered this option to be an appropriate solution to the problem created by a pseudo-commodity charge at entry. In their view this approach would be non-discriminatory, simple to implement and would ring-fence the adjustment within the NTS tier. The latter reason was highlighted by another respondent who also argued that this would be a

fair approach, since the increase in entry capacity prices has affected all shippers through increased gas costs. The first respondent also supported an equivalent discount for short-haul loads. In their view, Transco's concerns over maintaining cost-reflectivity in the NTS commodity charge itself were unfounded, being of the opinion that the whole of the NTS income would remain cost-reflective. Another respondent supported a partial adjustment to the NTS commodity charge to compensate for high prices paid by consumers. Two others also supported an adjustment to the NTS commodity charge as part of the solution.

One respondent supported introducing a target revenue and deadband approach of +/- 25% of the annual revenue target, to ring fence in principle the NTS charging tier and to amend any remaining imbalance through adjustments to the commodity tier prior to the next NTS entry capacity auctions. However, they questioned whether any ex-post changes to current rules are merited. This respondent stated that there has been no proof that either the capacity auctions have moved the forward price curve to the extent seen nor that any of the correction mechanisms proposed would have an equal and opposite effect on the curve.

In general, criticisms of this option were similar to those advanced against option A: the provision of cross-subsidies, lack of cost-reflectivity and the subsequent creation of distortions in the market, concerns over effects on the NTS optional commodity tariff and about price instability.

One respondent commented that this option, as well as option C, would introduce windfall gains for those shippers supporting retail sales that have secured NBP supplies prior to the auction and that any solution involving cross-subsidy would carry the risk of raising expectations of a similar cross-subsidy in the future. Another expressed that they would be concerned if a change to the capacity/commodity split were introduced mid-way through a gas year and also argued that adjusting the NTS commodity charge would not serve to remove the forward price curve distortion. A further respondent noted that a reduction in the NTS commodity charge would benefit interruptible customers, but considered that this would be offset by price instability.

6 respondents highlighted different shipping activities as a factor to be considered. All noted that shippers that buy entry capacity are not necessarily those that pay the commodity charge due to the different shipping activities to and from the NBP. In a similar vein, one respondent felt it wrong to credit suppliers for a cost that shippers have borne.

Transco's Response

In PC53, Transco suggested that the introduction of SND-based MSEC auctions under the NGTA could be regarded as having effectively introduced a pseudo-commodity charge at entry.

An adjustment to the NTS commodity charge could leave some distributional impacts between shippers, particularly between those shipping to the NBP and those shipping from it. However, some respondents are of the view that such an approach would be appropriate in compensating for higher gas costs to consumers on this occasion. Transco recognises the differing arguments put forward, but believes that it may be argued that the net position for those shipping to and from the NBP is dependent on the degree to which prices at all stages of the gas chain adjust in response to the differing influences.

Transco is therefore of the opinion that an adjustment to the NTS commodity charge could at least form part of a solution to the present issue.

5. Option C - Adjusting NTS Exit Charges

No respondents favoured adjusting exit charges alone. One respondent favoured a hybrid solution involving exit charges which is included in the section covering option D.

Criticisms of this option were similar to those levelled against options A and B. These included the creation of cross-subsidies through distributional impacts, lack of cost reflectivity, difficulty in administration, discrimination against end users in certain exit zones and ineffective cost-targeting, especially with regard to shippers with large interruptible portfolios. Furthermore, one respondent argued that this option would cause market distortions because there is no longer any linkage between entry and exit of gas in the commercial market.

Transco's Response

In PC53 Transco sought views on this option but considered that such an approach would not be appropriate, principally because of the potential for creating distortions to the LRMC-based economic signals provided by exit charges and the disproportionate impact on interruptible loads. Respondents views have reinforced Transco's initial view that this option should not be pursued.

6. Option D - Adjusting Entry Charges

17 out of 31 respondents supported an entry-based solution, but there were variations in the precise mechanism favoured. 6 favoured a uniform scaling of entry prices and 10 favoured terminal specific adjustments. Whilst stating it did not support any of the options, one respondent did state that any rebate should be terminal specific. Another favoured returning revenue to shippers that had bought entry capacity, as in their view this would remove the impact on prices in the forward curve, but did not express a preference as to which mechanism should be employed. A further respondent offered support to this option and also supported a flat rate rebate across all terminals based on UDQIs. This respondent was strongly opposed to only the highest auction bids being adjusted.

6 respondents favoured uniform scaling of entry prices. Views advanced were that cost reflectivity could be restored, avoidance of further uncertainty about the future cost of entry capacity, minimise distortions through distributional effects both upstream and downstream, prevention of cross subsidy from large users to other gas consumers, a dampening of forward prices and price stability.

9 respondents supported a terminal specific solution. Many of these responses echoed views expressed by others that supported an entry based solution. However, some respondents felt that adjusting by terminal has advantages over uniform scaling because the revenue recovered by Transco at each terminal would be consistent with LRMC methodology and hence more cost reflective, the relative bidding positions of shippers would be maintained, the true relative value of gas at each terminal would be reflected and each terminal's contribution to over-recovery would be properly rebalanced. One respondent also noted that the MSEC auctions

revealed shipper “willingness to pay” and that shippers’ valuation of capacity would not be changed by a one-off rebate.

5 respondents made specific recommendations as to how a terminal specific adjustment should be calculated. One favoured a fixed price return based on over-recovery at each terminal, expecting that this mechanism would result in a flattening of the capacity price curve and would not disproportionately reward those shippers that bid highest in the auction process. Another believed that revenue redistribution should be calculated by subtracting unit over-recovery values for each month for each terminal from accepted bids. One expressed a preference that this should not be constrained to reserve prices. One supported reducing bid prices by terminal through the application of a pro-rata reduction. A further respondent recommended that all successful bidders should pay a revised price comprising the reserve price plus a terminal specific percentage of the price bid by the shipper which should be established such that Transco recovers LRMC revenue for each terminal.

One respondent proposed a hybrid solution between entry and exit capacity. The methodology proposed was that a ceiling price equal to 125% of LRMC is applied and any cost over-recovery at an ASEP between the reserve price and the ceiling price is then targeted / credited to exit capacity charges on a pro-rata basis. Any remaining cost over-recovery above the ceiling price should be targeted / credited to MSEC holders at each ASEP pro-rata to the price bid in each round to secure their capacity holdings.

Two respondents proposed a hybrid solution for the short term of adjusting the NTS commodity charge and adjusting entry charges. One believed that these two options best lent themselves to achieving the objective of neutralising the impact of a major redistribution of income. It also proposed that an element of the over-recovery should be held back to allow for greater flexibility whilst designing future auctions. The other respondent, however, proposed that all of the over-recovery should be returned before October 2000.

Criticisms of an entry-based solution came from 7 respondents. Two stated that trades may already have occurred at current prices. Two questioned the legality of an adjustment to the auction results. One respondent questioned how a party could gain entry capacity at a lower price than that posted by a failed bidder during the auction proper. Another thought that monies should be returned to all shippers whether they had bought capacity or not based on gas nominations for the relevant months. A further respondent did not support this option because they suspected gaming in the bidding strategies by some producers.

One respondent argued that this option would be unfair and counter-productive, and could reward the behaviour that may have led to the high bid prices. Another argued that an entry solution would be inequitable, would undermine the auction rationale and doubted that a reduction in NBP curve prices would result. Although it supported uniform scaling, one respondent thought that this option had minor drawbacks in that different terminals will be affected in an unequal manner and that some corrected prices may end up lower than the reserve prices in the auctions. Another respondent, however, thought that the latter point should not be of consequence.

One respondent did not support any rebate of over-recovery without a reduction in daily reserve prices. It was also concerned that a rebate will affect bidding strategies in future and have no mitigating impact on the increase in gas prices.

Transco's Response

In PC53, Transco expressed the view that, whilst any adjustment focused on adjusting entry charges could be seen as desirable in targeting the area where the revenue difference arose, and that it offers the potential to neutralise any undesired or unanticipated effects from the MSEC auctions, such an approach could also neutralise the beneficial impacts which the auctions have been introduced to deliver, i.e. efficient market signals about the true value of capacity at specific locations.

Transco is still of this view, and believes that it would not be appropriate to amend the transportation charging methodology such that the amount paid for entry capacity would differ from the amount bid in any future MSEC auctions.

However, just over half of all respondents have expressed a clear desire for an entry-based approach as a one-off solution in the present circumstances. Given this, Transco accepts that it may be appropriate for such an approach to be adopted in respect of part of the over-recovery generated as a result of the March 2000 MSEC auctions. However, any future mechanism should be discussed as part of the ongoing review process prior to the planned July 2000 auctions.

The majority of respondents that favoured this option also favoured one of various forms of terminal specific adjustments. Transco considers that a terminal specific as opposed to a uniform approach would return average charges at each terminal to administered prices, and thereby undermine part of the auction rationale. In addition, given the range of potential mechanisms for making terminal specific adjustments and the associated variance in the distributional impacts, Transco is concerned that all respondents have not had an opportunity to express their view on the options. Transco is therefore of the view that any adjustment to charges for entry capacity should be on the basis of uniform scaling.

7. Other Issues Raised in Representations

7.1 Rebates Based on Gas Flowed

One respondent supported a rebate based on UDQI for each terminal coupled with an adjustment to the NTS commodity charge, stating that this would not discriminate between either MSEC or non-MSEC holders and that capacity hoarding at terminals would be prevented. It believed that Transco have overstated the complexity of such a solution and would prefer to wait rather than rush through an unfair rebate.

Another supported a flat rate rebate based on UDQIs whilst also supporting the option to adjust entry charges. It argued that a UDQI solution would not undermine shippers' future bidding strategy and that shippers without a 'genuine' requirement for system entry capacity would be disincentivised from making speculation bids.

One respondent supported a rebate based on UDQI exclusively, based on the difference between the price individual shippers paid for entry capacity, excluding interruptible auctions, and the WAP of the highest 50% of bids for the first and second tranches or the reserve price (whichever is the greater). If this approach were to lead to less than 75% of the revenue over-recovery being returned it was suggested that consideration be given to using the WAP of the

top 50% of bids in the first auction tranche as the basis for the rebate, and if this still results in an over-recovery the remainder could be repaid through reducing the NTS commodity rate or through K. This respondent acknowledged that its suggestion was complicated and less easy to implement quickly.

One respondent supported a mechanism to credit over-recovered income each month in proportion to UDQOs. It argued that this solution would preserve price signals from the primary auctions, will not result in any cashflow benefit to Transco, has merits of symmetry, simplicity and low cost and would not discriminate between Users. It expressed great concern about the options detailed in PC53.

Transco's Response

Operational issues are likely to preclude prompt implementation of either the UDQI or UDQO options. In addition, Transco is mindful that a delay to the over-recovery being returned may cause disproportionate impacts according to shipper size in terms of cash flow. Given that the majority of responses have emphasised the need for prompt implementation of a revenue adjustment, Transco accepts this to be an important issue in deciding on a solution and that UDQI or UDQO options would not be suitable for this reason.

7.2 Precedent Setting

One respondent considered that implementation of a one off correction mechanism for the recent auctions would not set a precedent because the mechanism chosen on this occasion may not be that which may be required for the future. Another respondent's view was that any changes made to the present auction results do not set a precedent for future unwinding of capacity volumes or prices. Similarly, another 4 noted that to implement a one-off solution is without prejudice to, and must not set a precedent for, any future proposals for revenue redistribution that might be considered following subsequent auctions. One respondent stated that their proposal should be used as a one off and not used to establish any future revenue adjustment mechanism. Another did not consider that an early adjustment should set a precedent.

However, One respondent considered that the option to adjust entry charges would set a precedent for shippers to pay high prices for entry capacity and expect a rebate, whilst another stressed that its preferred entry based solution should only be used as a one off adjustment since it could set a precedent for behaviour in future auctions. Another respondent believed that there is no precedent for using a revenue reapportionment mechanism other than K and that to adjust entry charges would create one. A further respondent considered that reducing the MSEC bids or some other charge reduction would set a precedent, sending a message to the industry that if auctions fail to deliver the expected results then those results can be changed.

Transco Response

Transco does not believe that any immediate solution should be regarded as setting a precedent, but remains concerned that this may be unavoidable. In view of this, Transco believes that the arrangements, should a similar situation arise in future, should be agreed by the community prior to the next round of MSEC auctions.

Transco does not believe that it would be appropriate to create any expectation that it would in future amend the transportation charging methodology such that the amount paid for entry

capacity would differ from the amount bid in MSEC auctions. The capacity regime and auction methodology are still evolving and Transco intends to work with Ofgem and the industry to achieve improvements which would aim to reduce the likelihood of such a large variation from target entry capacity revenue in future. In the light of responses to PC53, Transco accepts that a one off solution is appropriate for the recent auctions.

7.3 MSEC Auction Methodology and Future Adjustment Mechanisms

4 respondents supported a review going forward to establish a mechanism for future revenue adjustments following the outcome of auctions. One stated that it should be considered. Another considered such a discussion totally inappropriate at this time and one did not think it appropriate to comment at this time. Another did not support any changes to the wider transportation charging methodology at this time. 3 others considered that priority should be given to addressing issues associated with the capacity regime before any future adjustment mechanism was agreed. A review of auction methodology was supported by 10 respondents. Another respondent thought that the K factor may be the most suitable method for future adjustments if they prove to be necessary.

One respondent hoped that a better, cheaper way of allocating capacity than auctions can be found before October 2000 and another thought that a return to administered entry charges should be implemented. The first respondent argued that the impact of auctions on its members, and on all UK gas customers has been extremely detrimental because they have pushed up wholesale gas prices, charged market participants monopoly prices for capacity and added to price instability. As a longer term solution, this respondent proposed that capacity is allocated on a historical basis with a system for secondary trading of capacity to achieve efficient allocation. Further, they believed that Ofgem should review the competitive positions of companies in the gas market. Another respondent's view was that auction theory is inappropriate for the industry and has increased the wholesale price of gas. One respondent stated that it remained to be convinced of the benefits of entry capacity auctions.

3 respondents thought that high prices have been generated due to flaws in the auction design and by Transco not releasing adequate quantities of MSEC. One of these respondents regarded such structural problems as more significant than the issue of rebalancing of revenues generated from the auctions and believed that a work group should be set up urgently to look at the real availability of system entry capacity at each terminal. Further, they saw no need for auctions to be applied outside periods of potential constraint.

Transco's Response

Transco agrees that there should be further debate about the arrangements surrounding the future sale of entry capacity.

7.4 Upstream Impacts

One respondent stated that since the introduction of Network Code many upstream agreements have been indexed on the relative gas value at the entry terminal and that there has been considerable distortion in the terminal specific markets and hence reference prices. It argued that anything other than a terminal specific entry solution could negatively impact long term investment signals for future oil and gas developments in the North Sea. Another respondent made a similar point, stating that producers considering a UK option for marketing of future new gas supplies have seen a step change in entry capacity price risk and in the

absence of long term signals have little choice but to factor current price risk into their investment decisions.

Transco's Response

Transco is unable to comment on the nature of upstream agreements to which it is not party, nor whether the present position is impacting upstream investment.

7.5 DSEC Impacts and Reserve Prices

15 respondents supported a consequential reduction in DSEC reserve prices. One added that this would allow shippers with little or no MSEC to buy on the daily market at a more cost reflective price. 3 argued that this would have positive effects on capacity market liquidity. On this issue one respondent expected that Transco should reduce the daily and within day firm reserve prices to the equivalent of the monthly reserve prices as a minimum, but expressed a preference for removing reserve prices altogether. Further, it argued that uniform scaling of MSEC bids will still lead to DSEC reserve prices being at such a level that the availability of capacity is restricted.

Transco's Response

Transco agrees that if entry charges are reduced from the levels bid in the MSEC auctions, it would be appropriate for the reserve prices in daily auctions to be reduced.

8. Conclusion

Transco welcomes the high level of response to the consultation paper. While responses contain a variety of views, Transco notes the majority view that there should be an early adjustment to charge levels. Transco also notes that the majority of respondents favour an approach focused on adjusting entry charges. In light of these responses, Transco accepts that it may be appropriate in the present circumstances to apply a one-off adjustment to entry charges. However, given the diversity of distributional impacts referred to by respondents, Transco proposes that there should also be an adjustment to the NTS commodity rate, and that some over-recovery should be carried forward. This over-recovery will be reflected in revised transportation charges which will be set in accordance with accepted practice.

9. Transco's Proposal

Transco proposes that, with effect from 1 May 2000, until 30th September (inclusive) changes be made to the transportation charging methodology as follows:

The standard NTS commodity charge should be reduced by 42% from the level set out in the publication "Gas Transportation Charges from 1st May 2000".

A reduction in the standard NTS commodity rate does not affect the optional tariff, however, in the present circumstances, and bearing in mind that there would otherwise be an

incentive for some customers to revert to the standard tariff, the applicable optional NTS commodity rate should also be reduced by 42%.

A scaling factor should be introduced, such that the charges payable for MSEC shall be the amounts bid for MSEC at each entry point, reduced by 42% where such scaling results in a value higher than the published floor price for monthly system entry capacity at the relevant entry point. Otherwise the scaling factor should be such that the amount payable is equal to the relevant MSEC floor price.

The charge payable for unsold monthly capacity shall be the average of the top 50%, by volume, of MSEC charges payable, (bid prices after adjustment) in ranked price order.

Floor prices for auctions of firm daily capacity should be set at 1.0 times the average of the top 50%, by volume, of MSEC charges payable (bid prices after adjustment) in ranked price order.

Floor prices for auctions of interruptible daily capacity should be set at 0.1 times the average of the top 50% by volume, of MSEC charges payable (bid prices after adjustment) in ranked price order.

These proposals are expected to reduce charges to shippers by about £73m for the period 1 May to 30 September, and to leave about £13m to be carried forward under the terms of the price control formula. This is broadly consistent with the suggestion in PC53 of allowing NTS entry capacity revenue to vary within a 25% tolerance band around the target level.

Implementation of these proposals in time for 1 May 2000 is dependent on implementation of Network Code Modification Proposals both to waive the two months notice requirement and to determine the price payable for MSEC by reference to the multiplier 0.58 (or variable, as appropriate) rather than the prices originally bid in the March MSEC auction. The revenue adjustment factor will be published in a statement of revisions to Transco's transportation charging statement.