January 2004

TRANSCO CONSULTATION REPORT ON PC77

NTS TO Commodity Charge

1. Introduction

In PC75[1] Transco proposed the introduction of a TO commodity charge as a means to deal with potential over or under recovery of TO revenue arising from fluctuations in other TO charges. The existing arrangements rely upon any over recovery of revenue being redistributed in line with User entry capacity holdings[2] and then potentially an adjustment to NTS exit capacity rates depending on the degree of forecast revenue variance to target. Changing NTS exit capacity charges is the primary means for dealing with revenue under recovery. Transco considered that neither arrangement was satisfactory as the primary mechanism for revenue adjustment, as outlined within PC75 and subsequent papers.

The implementation of PC75 was vetoed by Ofgem due to its concerns over the lack of transparency and certainty of how the proposed charge would be set and adjusted. However, Ofgem recognised that such a charge may be appropriate provided these issues were addressed. Having considered these points carefully and consulted with the industry via PD17[3], a consultation paper PC77[4] was issued in July 2003. The paper set out Transco's proposed introduction of a TO Commodity charge for potential introduction from December 2003.

2. Transco's Initial Proposal

Pricing Consultation PC77 sought views on a change to the transportation charging methodology with the proposed introduction of an NTS TO commodity charge, this following industry discussion within Pricing Discussion paper PD17. If the NTS TO revenue obtained from other charges were in line with target levels then it would be expected that the NTS TO commodity charge would be zero. If the NTS TO revenue were out of line with the target level, then the NTS TO commodity charge could be adjusted accordingly. The NTS TO commodity charge could be positive or negative, although a limit would be set on its negativity.

This methodology would take precedence over that established by PC65 and subsequently adjusted by PC67, hereafter referred to as the PC65 mechanism. However, the PC65 mechanism would be retained for situations where the limit on the negativity of the NTS TO commodity charge rate meant that a further adjustment to revenues was required.

It was also proposed that the TO commodity charge would be applied on an identical structural basis to the SO commodity charge. At present, the SO commodity charge is applied only to exit flows. However, from October 2004 it will be applied to both entry and exit flows, each at 50% of the full rate. The TO commodity charge would therefore also be applied on this revised charging basis from October 2004.

[1] PC75 NTS TO Commodity Charge July 2002
[2] The "PC65 Mechanism" as later revised by PC67
[3] PD17 Setting of NTS Transportation Charges January 2003
[4] PC77 NTS TO Commodity Charge July 2003

The TO commodity charge could be negative, however, our intention would be to limit the extent of its negativity such that, in combination with the SO commodity charge, the combined commodity charge would not be lower than the estimated short-run marginal cost of operating the NTS. This would ensure that the combined commodity charge would not encourage inefficient use of the NTS.

Transco was not proposing to modify the optional NTS commodity charge but clarified how the charge would operate if a TO commodity charge were introduced.

3. Summary of Responses

Comments and views were invited on the issues raised in the consultation paper PC77 NTS TO Commodity Charge.

Transco received eleven responses to the consultation, which are summarised below:

Respondents	Code
Statoil (U.K.) Ltd	STA
Scottish & Southern	SSE
Innogy	INN
ConocoPhillps	CoP
Total Gas & Power Limited	TGP
Shell Gas Direct Ltd	SGD
PowerGen	POW
Scottish Power	SCP
British Gas Trading	BGT
Association of Electricity Producers	AEP
Corus UK Ltd	COR

Four respondents (SSE, POW, BGT, TGP) were in favour of the introduction of a TO Commodity Charge, with SSE expressing support only where entry Users were targeted by the proposal rather than it being an exit and entry flow commodity charge. Five respondents (CoP, INN, SGD, AEP, SCP) were against the proposal. Two respondents (STA, COR) provided comment and gave no opinion for or against the proposal, with STA stating that more time was required to assess the impact of long term auctions.

Three respondents (BGT, POW, TGP) favoured the TO commodity charge being applied as the primary adjustment mechanism should an over recovery of TO revenue occur, and in preference to the PC65 mechanism. Four respondents (SGD, SSE, AEP, INN) were against this.

Five respondents (POW, BGT, TGP, SCP, CoP) supported a TO commodity charge having the same structure as the SO commodity charge with four (AEP, SSE, STA, INN) objecting on grounds that an adjustment mechanism for entry over or under recovery of revenue should only target entry Users.

Six respondents (SSE, CoP, INN, AEP, POW, BGT) were in favour of retaining the Optional Commodity charge. One respondent (SCP) raised concerns that the optional commodity tariff could be further anomalised by the introduction of a TO charge applied to entry and exit flows.

Detailed Responses:

Transportation charge stability

Three respondents (SSE, SCP, AEP) expressed a preference for annual price setting in order to promote transportation charge stability. SSE commented that the move to an annual MSEC process supported this objective. Two of these (AEP,SCP) expressed disappointment that Transco was still proposing within year changes, as part of this proposal, with consequences for charge stability.

STA expressed a concern that the TO Commodity charge could introduce more volatility in transportation charges since Transco sells entry capacity up to within-day thus making the total level of revenue recovery unknown until after the day, and so difficult to predict.

Transco's response

Transco considers that the introduction of a TO commodity charge should improve the stability and certainty of transportation charges, particularly where the circumstances and process for applying such a charge are known to shippers and gas consumers alike.

Recognising shippers' desire for stability and certainty, it is Transco's intention to apply the TO commodity charge in such a way that, except in extreme circumstances, shippers would be notified, in advance, of the level of the TO commodity charge in respect of the full 12 month period commencing each October. Such a 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.

The most likely 'extreme circumstance' that could cause Transco to adjust the TO commodity charge outside of the annual cycle described above would be a major variance between actual and target auction revenues. In such a case, the earlier implementation of a TO commodity charge rate adjustment could mitigate the extent of the change required and contain the adjustment within the financial period.

Indicative analysis by Transco suggests that the TO commodity charge may be able to handle an over recovery against target entry capacity revenue of the order of 40% to 50% and still contain the adjustment to forecast revenue within the appropriate formula year i.e. by 31st March. This assumes a change of the charge rate in October and that a TO commodity rate is restricted by the combined NTS TO and SO commodity rate being no lower than the set minimum level. Clearly, an adjustment earlier than October would allow for greater revenue variance to be handled by the TO commodity charge, albeit reduced system throughput over the summer months would serve to limit the benefit of earlier implementation.

Transco agrees with Statoil that total entry revenue cannot be entirely predicted from long term QSEC and annual MSEC processes. However, Transco considers revenue arising from rolling MSEC and daily sales of capacity to have a relatively minor effect on its ability to forecast entry revenue since experience to date suggests that Shippers will have secured the large majority of their capacity requirements during earlier auctions. In addition, long term capacity auctions should reduce the volatility of total revenue from auctions since less capacity is allocated through MSEC processes.

Transco believes that the introduction of a TO commodity charge will make it very unlikely that an adjustment to NTS exit capacity charges will be necessary as a result of entry capacity auction revenue recovery. Consequently cost reflectivity will be improved because

LRMC signals will be less likely to be distorted from the standard level under a TO commodity approach than they would under the current arrangements. It is important that transportation charges continue to present cost-reflective locational signals to existing and potential new users of Transco's NTS system in order to provide Transco with appropriate investment signals. Additionally, the NTS SO Exit Investment incentive at present relies on a valuation of interruptible capacity costs based on firm NTS exit capacity rates; the use of a TO commodity charge as proposed protects the intent of this incentive.

TO commodity charge having same structure as SO commodity charge

Five respondents (POW, SCP, TGP, CoP, BGT) were in favour of the TO commodity charge having the same structure as the SO commodity charge. Two of these (TGP, CoP) stated that a recovery from entry and exit flows would be more cost reflective. Four respondents (AEP, SSE, STA, INN) opposed a common charge structure on grounds that they believe the charge should be applied to entry flows only. Three of these respondents (AEP, INN, SSE) expressed a concern that the ease of administration should not be a major factor in justifying a common structure.

Transco's response

The proposed TO commodity charge is intended as a TO revenue adjustment mechanism and does not reflect the cost of any particular TO services. As such, the issue of the structure of the charge in terms of reflecting how particular costs are incurred does not arise. However, it is important that the introduction of such a charge does not undermine the cost-reflectivity of the present exit charges or the intent of the entry capacity auction mechanisms.

The TO commodity charge may be positive or negative dependent upon whether forecast revenue recovery would otherwise be above or below the maximum allowed level. This is expected to reflect primarily User behaviour within entry capacity auctions but will also cover the possibility of RPI or "K" being different from previously forecast. As such, Transco considers that basing the TO commodity charge solely on entry commodity flows would be more likely to distort the entry capacity auctions since a countervailing entry commodity adjustment would be focused more tightly on the shippers involved in the auction and this would be known in advance of the auction.

Basing the TO commodity charge on both entry and exit commodity charge flows enables a higher maximum level of revenue variation to be handled through the mechanism compared to either an entry flow or exit flow based mechanism (assuming the same set minimum overall rate) and so reduces the likelihood of a change to the NTS exit capacity charges being required, so retaining their cost-reflectivity as initially set.

In addition, Transco is of the view that a common TO and SO commodity structure promotes simplicity for both Transco and users in terms of minimal change to business processes and the avoidance of industry I.T. costs associated with a separate TO charging mechanism.

Consequently, Transco is of the opinion that the TO commodity charge should be applied equally to exit and entry flows (from October 2004) and share an identical structure to the NTS SO commodity charge.

Transco proposes to clearly identify the TO and SO commodity rate components and methodology for application within its Transportation Statement.

TO commodity charge taking precedence over the PC65 mechanism

Four respondents (BGT, TGP, POW, SCP) were in favour of the TO commodity charge taking precedence over the PC65 mechanism should an over recovery of entry revenue to occur. Five respondents (INN, STA, AEP, SSE, CoP) were against the TO commodity charge taking precedence over the PC65 mechanism, with four (INN, STA, AEP, CoP) of these objecting in principle to a TO commodity charge being introduced at this stage. Objection centred on grounds that any adjustment should be targeted to entry Users (STA, AEP, INN, SSE) or that the PC65 mechanism could be modified negating the need for a TO commodity charge (AEP, SSE, CoP).

Transco's response

Transco agrees with those respondents (BGT, TGP, POW, SCP) who considered that a TO commodity charge should be the primary means for adjusting over or under recovery of TO revenue against target revenue resulting from auction processes because the PC65 mechanism is unstable in its impact and therefore makes it difficult for Transco to set stable charges. It is envisaged that the application of a TO commodity charge will under most circumstances result in a satisfactory adjustment to resolve revenue recovery variance within a suitable timeframe without recourse to other adjustment mechanisms, as described earlier within this document. Transco considers that it would be prudent to retain the PC65 mechanism, as a secondary measure, should significant over recovery of entry revenue occur that might not be resolved without recourse to an overall commodity rate set below the short run marginal cost of running the NTS. Consequently, Transco proposes to apply the TO commodity mechanism in preference to the PC65 mechanism, with the PC65 mechanism being used where the TO commodity charge is as negative as permitted by the methodology. Transco does not consider that modifying the PC65 mechanism such that it is invoked at a lower level of over recovery of revenue would address the concerns stated previously of transportation charge stability or the potential for distortion of the entry capacity pricing signals.

The proposal to use a TO commodity charge as the primary mechanism for adjusting for forecast over-recovery would provide greater stability and certainty compared with the present PC65 mechanism. The level of revenue flowing to shippers via the PC65 mechanism depends directly on the level of entry capacity buy-back costs that Transco incurs. It is therefore not guaranteed to adjust revenues close to any target, and the actual revenue flows associated with the mechanism cannot be accurately predicted. Retaining the PC65 mechanism as the primary adjustment would therefore give less charging stability.

The Optional SO Commodity Tariff

Six respondents (SSE, CoP, INN, AEP, POW, BGT) were in favour of retaining the Optional Commodity charge. One respondent (SCP) raised concerns that the optional commodity tariff could be further anomalised by the introduction of a TO charge applied to entry and exit flows

Transco’s Response

Transco is not proposing as part of this process to modify the optional commodity charge given the level of support from respondents for this mechanism. This optional charge will be an alternative to the combined TO and SO commodity charge.

Transco is considering a review of the SO commodity charging methodology. This follows recent developments to modify the standard NTS SO commodity charge (entry and exit flows) and the Authority’s statements in its recent decisions on a number of Network Code

Modification Proposals and Pricing Consultations, most recently within Modification Proposal “0626: Structure of the NTS SO Commodity Charge”.

Implementation Date

There was no strong preference from respondents on the timescale for the introduction of a TO commodity charge, although BGT expressed a view that, if implemented, an early introduction would be sensible to address forthcoming MSEC auctions and suggesting April 04. Of the two respondents (TGP, STA) that suggested an alternative date, namely October 2004, they did so in order to potentially avoid introducing two commodity charge changes in one year given the intention to split NTS commodity from October 2004 between entry and exit flows.

Transco's response

Transco considers that the impetus for a December 03 implementation was negated by the recent MSEC auction outcome. However, given the forthcoming Annual MSEC auction[5], Transco would consider it prudent to introduce the proposed TO commodity charge on 1st April 2004, initially set to zero. It would subsequently be modified in accordance with the process described under ‘Transportation Charge Stability – Transco’s Response’, above.

More information on the TO commodity charge

One respondent (STA) questioned why Transco had proposed a minimum charge of 0.0022 ppkwh for the combined NTS TO and SO commodity charge.

Transco's response

The minimum charge of 0.0022 ppkwh is the previously estimated marginal SO cost below which inefficient use of the transmission system would be encouraged, as set out in Transco’s report on PC60[6] (July 2000).

Potential for a Sizeable Positive TO commodity charge

Three respondents (AEP, TGP, POW) were concerned by recent trends in entry capacity auctions increasing the likelihood of significant under recovery, which could lead to a sizeable TO commodity charge. One respondent (TGP) suggested introducing the charge between certain tolerance percentages to avoid large charges.

Transco's response

Transco recognises that a sizeable TO commodity charge could result from application of the TO commodity charge mechanism should there be a significant under recovery of revenue from the entry capacity auctions. It is Transco’s aim to ensure that auction mechanisms work on an efficient basis where Users are able to signal their demand and value for the entry capacity product. However, Transco recognises that market mechanisms may not always delivery a predictable result. Consequently, Transco accepts that the potential for a positive TO commodity charge exists but continues to believe that the TO commodity mechanism is the appropriate means for adjusting revenue variance whether

5 February 2004

6 PC60 Re-Balancing Revenue Raised by MSEC and Other NTS Auctions - July 2000

this be positive or negative. Transco's total level of revenue is capped by its TO price control, which acts to place a ceiling on any positive extent of the TO commodity charge.

4. Conclusion

Transco welcomes the comments received in response to the proposals contained within PC77. A wide variety of views on the issues raised within the paper have been aired.

Transco agrees with those respondents who expressed the view that the TO commodity charge structure should be aligned with the SO commodity charge structure with the charge to be applied to both entry and exit flows from October 2004. We note the responses concerning charge stability, and particularly in respect of annual charge setting.

Taking account of these comments and concerns, Transco proposes to introduce a TO commodity charge with the intention that it would publish changes to the TO commodity charge annually in respect of the 12 months commencing each October, unless exceptional circumstances dictate otherwise.

Transco therefore proposes:

- That an NTS TO commodity charge be introduced, additional to the NTS SO commodity charge, which would be used to adjust the level of TO revenue if there is forecast to be significant over or under recovery of TO revenue against the maximum allowable TO revenue following the AMSEC auctions;

- That the TO commodity charge will be set to have a zero rate where forecast TO revenue is in line with target revenue;

- That the NTS TO commodity charge should have an identical structure at all times to the NTS SO commodity charge and that the minimum negative NTS TO commodity charge should be such that, in combination with the NTS SO commodity rate, the combined effective NTS commodity rate should not be lower than 0.0022ppkWh, which is the estimated short-run marginal cost of operating the NTS;

- That the TO commodity charge will be the primary mechanism for adjusting any forecast TO revenue over or under recovery against TO maximum allowed revenue;

- That the PC65 Mechanism is retained as a secondary method for revenue adjustment to be used should the combined TO and SO commodity charge have reached its minimum level;

- That the optional commodity charge is retained as an alternative to the combined TO and SO commodity charge;

- That the TO Commodity charge be introduced for April 2004 with a zero rate.