



Shippers, Transco and other interested parties

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Dear Colleague,

**Pricing Consultation Paper PC 77 - NTS TO Commodity Charge**

Transco raised Pricing Consultation (PC) 77 '*NTS TO Commodity Charge*' in July 2003 and published its PC 77 report on 5 January 2004 (January 2004 report). Ofgem held an informal consultation in order to seek views on Transco's proposals, as set out in its January 2004 report. The consultation closed on 19 January 2004.

Ofgem has carefully considered the views of the respondents to this pricing consultation. Ofgem has decided to veto this proposal because we do not believe that the proposal better facilitates the relevant objectives of Transco's charging methodology, as set out in amended standard condition 4A of Transco's Gas Transporter (GT) licence.

The reasons for this decision are set out in the accompanying paper.

As a result of vetoing this proposal, the current mechanisms for rebalancing any under or over recovery of revenues against that allowed under Transco's National Transmission System (NTS) Transmission Asset Owner (TO) price control shall remain in place.

In respect of future over recoveries, the mechanism established under PC 65, '*Alternative Method of Funding Entry Capacity Constraint Management*', as adjusted by PC 67, '*Technical Adjustment to PC65 Mechanism*', will continue to operate. PC 66, '*Transportation Charge Adjustments Following Entry Capacity Auctions*', will continue to provide the mechanism in the event of an under recovery.

In raising this consultation, Transco proposed to introduce a TO commodity charge to allow for the redistribution of over or under recoveries of TO revenue to operate alongside the mechanism established under Pricing Consultation PC 65 as amended by PC 67. This TO commodity charge would be applied on an identical structural basis to the System Operator (SO) commodity

charge and could be positive or negative, although a limit would be set on its negativity. This methodology would take precedence over PC65 with the latter being applied in situation where the limit on the negativity of the TO commodity charge meant that a further revenue adjustment was required.

The majority of respondents were against Transco's proposal. A number of respondents believed that the proposed re-balancing charge should be targeted to entry system users and that there was merit in retaining the current PC 65 mechanism for dealing with over recoveries. Respondents were also concerned that introducing a new charge would increase uncertainty and instability within the charging regime. The views received to this consultation are discussed in more detail in the accompanying paper.

Ofgem agrees with the principle underlying the proposal to introduce a rebalancing charge to deal with revenue over and under recoveries of TO revenue. As we stated in our letter on Pricing Consultation 75 (PC 75) '*NTS SO Commodity Charge*' we consider that there is a need for a rebalancing mechanism in Transco's charging methodology to allow for the collection or redistribution of TO revenue under or over recovery. In particular, Ofgem considered that it was undesirable to adjust exit capacity charges in the event of a TO over or under recovery, as under the current arrangements.

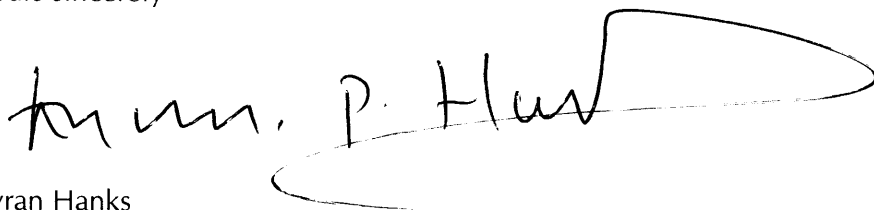
However, Ofgem does not consider that this proposal should be implemented under Transco's proposed framework, given the ongoing concerns raised by shippers about the potential increased uncertainty in the level of transportation charges, the proposed structure of the TO commodity charge and Transco's proposed use of PC 77 as the primary function for dealing with over recoveries.

In particular, Ofgem has concerns that PC 77 would take precedence over the PC 65 mechanism under this proposal, thereby resulting in a potential increase in the number of changes to charges within a formula year in its current form.

We consider that the proposed mechanism could be further developed in order to address the concerns expressed by respondents about the need for increased charging stability and for an appropriate targeting of any revenue under or over recovery redistribution to system users. Ofgem would therefore welcome further proposals on an appropriate TO redistribution mechanism.

If you have any further questions on this letter or the accompanying paper, please do not hesitate to contact me on the above number or Tolani Azeez on 020 79017043.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kyran Hanks', with a large, sweeping flourish extending to the right.

Kyran Hanks  
**Director, Gas Trading Arrangements**

## **Ofgem's views on Transco's proposal to introduce the NTS TO commodity charge (PC77)**

### **Background**

Ofgem published its modifications to Transco's Gas Transporter (GT) licence for 2002-2007 on 27 September 2002. The modifications introduced Transco's National Transmission System (NTS) System Operator (SO) incentives and its Transmission Asset Owner (TO) price control, with effect from 1 April 2002. These modifications separate the regulation of Transco's role as TO, whereby it builds and maintains the NTS, from its role as NTS SO, whereby Transco determines the need for additional capacity and the day to day operation of the system.

Under Special Condition 28B of its GT licence, Transco is obliged to use its best endeavours in setting charges to ensure that in respect of any formula year the revenue which it derives from its NTS TO activity shall not exceed the maximum TO revenue set under its licence.

The current arrangements for rebalancing any over or under recovery of TO revenues are set out in PC 65 '*Alternative Method of Funding Entry Capacity Constraint Management*', as amended by PC 67 '*Technical Adjustment to PC 65 Mechanism*' and PC 66 '*Transportation Charge Adjustments Following Entry Capacity Auctions*'.

In the event of an over recovery, PC 65 (the buy back fund) established a methodology whereby Transco rebates excess revenue by offsetting shippers' exposures to the costs of buy backs. The buy back fund is utilised when auction revenue exceeds target revenue by 10 percent or more. This excess revenue is divided into six equal monthly amounts and where the buy back fund exceeds aggregate shipper buy back costs in a particular month, the excess amount is carried forward to the next month. Any remaining over-recovery after the end of the first half of a formula year is carried forward into the buy back fund for the second half of the year.

PC 66 provides for adjustments to the general level of transportation charges in the event of an under-recovery.

In July 2002, Transco raised PC 75 '*NTS SO commodity charge*' which proposed to introduce a TO commodity charge to allow for the redistribution of over or under recoveries of TO revenues. Ofgem vetoed this proposal because it considered that it was insufficiently developed and it lacked transparency as to the methodology that Transco would use in setting the charge.

### *Pricing Discussion Paper PD 17*

In January 2003, Transco published Pricing Discussion Paper PD17 *Setting of NTS Transportation Charges*. Transco re-stated its proposal to introduce an NTS TO commodity charge as a means of adjusting for variations in the level of actual revenues compared to its allowed revenue. Transco sought views from respondents on whether it would be beneficial to introduce a TO commodity charge and the frequency with which such a charge would be re-set. Transco considered that there was merit in all NTS TO charges being set at the same time, covering a whole formula year, including a TO commodity charge which reflected the level of anticipated over or under recovery carried forward to that formula year.

## **Transco's initial proposal**

In its July 2003 PC 77 paper, Transco proposed a change to the transportation charging methodology in which an NTS TO commodity charge would be established based upon the proposals outlined in PD 17. Transco proposed that if the NTS TO revenue obtained from the other charges were in line with target levels then 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. Transco also proposed that the NTS TO commodity charge could be positive or negative, although a limit would be set on its negativity. The methodology would take precedence over PC 65 and would be levied on entry and exit users based upon flows. Transco suggested that the PC 65 mechanism could be retained for situations where the limit on the negativity of the NTS TO commodity charge rate would require a further adjustment to revenues. Finally, Transco proposed not to change the optional commodity charge, which offers a discounted NTS commodity rate for loads located close to NTS system entry points. The optional commodity charge would still be available as an alternative to the combined TO and SO charges.

## **Respondents' views**

There were eleven responses to PC 77 and a further four responses to Ofgem's extended consultation on Transco's PC 77 report. Most respondents recognised the need for a TO rebalancing charge, but they expressed concerns with the proposal in its current format. Two respondents offered qualified support, but the majority of respondents opposed the introduction of the charge.

### *Pricing stability*

Respondents considered that, given the unpredictability of auction revenue recovery, the level of the TO commodity charge under Transco's proposed methodology could be volatile. A small number of respondents agreed with Transco that pricing stability could be improved by moving the charges away from the uncertainty associated with buyback costs.

### *Structure of the TO commodity charge*

Some respondents considered that the TO commodity charge should only be levied on entry capacity users. None of these respondents believed that basing the TO commodity charge solely on entry users would be likely to distort the entry capacity auctions.

One respondent queried why a TO commodity charge would need to have a limit to its negativity.

### *Precedence of PC 77 over PC 65*

Some respondents did not consider that PC 77 should take precedence over PC 65. In particular, a number of respondents considered that the current PC 65 mechanism should be retained, albeit in a modified form. Respondents considered that the current PC 65 methodology could be enhanced to function in a more efficient manner. In this respect, respondents to Ofgem's consultation on Transco's PC 77 report suggested a number of modifications, including reviewing the excess on target level of recovery at which the PC 65 mechanism would be recovered, or assigning all of the buyback fund to the first month and rolling any excess into the remaining months.

One respondent considered that Transco should retain the current PC 65 arrangements until it had identified where a more robust methodology could be needed.

#### *The Optional SO commodity tariff*

The majority of respondents who commented on this aspect of the proposal supported the retention of the optional SO commodity charge alongside the introduction of a TO rebalancing mechanism.

#### *Notification of changes to charges*

The majority of respondents to Ofgem's consultation on the PC 77 report supported Transco's proposal to provide 2 months notice of changes to charges for a 12 month period except in exceptional circumstances. Respondents placed considerable weight on the importance of pricing stability and certainty and they therefore welcomed the possibility of an annual TO transportation charge.

One respondent expressed a preference for transportation charges to be adjusted twice a year in order to avoid large step changes.

#### *Implementation date*

Of those respondents who commented on the implementation date, most respondents considered that PC 77 should be implemented from October 2004, if the charge were to be levied on entry and exit users. Respondents believed that this would avoid an additional change to the charging structure within year.

#### **Transco's views**

Transco stated that the introduction of a TO commodity charge would improve the stability and certainty of transportation charges, particularly where the circumstances and process for applying such a charge were known to shippers and end users.

#### *Pricing stability*

Transco recognised that shippers require stability and certainty. It stated that its proposed methodology under PC 77 would achieve this by notifying shippers in advance of the level of the TO commodity charge in respect of the full twelve month period commencing each October.

Transco believed that the introduction of TO commodity charge would make it very unlikely that an adjustment to the NTS exit capacity charges would be necessary as a result of entry capacity auction revenue recovery.

#### *Structure of the TO commodity charge*

Transco considered that the TO commodity charge would be a TO revenue adjustment mechanism and therefore did not need to reflect the cost of any particular TO services. Transco therefore considered that basing the TO commodity charge solely upon entry commodity flows would be more likely to distort the entry capacity auctions by encouraging overbidding, since a countervailing entry commodity adjustment would be directed to shippers who have bid successfully in the auction.

Transco also believed that basing the TO commodity charge on both entry and exit flows would enable a higher maximum level of revenue variation to be handled through the proposed mechanism, thus reducing the likelihood of an adjustment to NTS exit capacity charges.

Transco proposed that a minimum combined TO and SO commodity charge would ensure that Transco covered the previously estimated short run marginal cost of operating the NTS of 0.0022 p/kWh.

#### *Precedence of PC 77 over PC 65 mechanism*

Transco considered that the current PC 65 mechanism depends directly upon the level of entry capacity buy back costs that Transco incurs. It is therefore not guaranteed to adjust revenues close to target. Transco stated that the current arrangements make it difficult to set stable charges. It envisaged that the application of a TO commodity charge as a primary mechanism for TO under or over recovery would, under most circumstances, result in a satisfactory adjustment to resolve revenue recovery variance within a suitable timeframe. Under its proposal, the PC 65 mechanism would be retained as a secondary method for revenue adjustment to be used if the combined TO and SO commodity charge reached Transco's proposed floor price.

#### **Transco's final proposals**

Transco put forward the following final proposals in its pricing consultation report:

- the introduction of an NTS TO commodity charge additional to the NTS SO commodity charge, which would be used to adjust the level of TO revenue in the event of a TO under or over recovery;
- the TO commodity charge would be introduced from April 2004 with a zero rate and would remain at a zero rate where forecast TO revenue was in line with target revenue;
- the NTS TO commodity charge would have an identical structure to the SO commodity charge, such that in combination with the NTS SO commodity rate, the combined effective NTS commodity rate would not be lower than 0.0022 p/kWh (the estimated short run marginal cost of operating the NTS);
- the TO commodity charge would be the primary mechanism for adjusting forecast TO over or under recovery. The PC 65 mechanism would be retained as a secondary method for revenue adjustment; and
- the optional SO commodity charge would be retained as an alternative to the combined TO and SO commodity charge.

#### **Ofgem's views**

Having carefully considered this pricing consultation and respondents' views, Ofgem has decided to veto this proposal.

As we stated in our decision letter on *PC 75 NTS TO Commodity charge*, Ofgem supports the need for and the concept of a revenue rebalancing mechanism to address over or under recoveries in TO revenues. We continue to consider that it is inappropriate for Transco to adjust

exit capacity charges in the event of a TO under recovery as a result of entry capacity auctions. We are therefore of the view that the concept of a TO commodity charge has considerable merit.

However, Ofgem considers that the PC 65 mechanism should take precedence over PC 77, thus allowing the buy back fund to function as the primary mechanism to deal with over recoveries.

Ofgem continues to support the intent of PC 65, which, in the event of an over-recovery, provides for any excess revenue (above allowed TO revenue plus ten per cent) to be offset against entry capacity holders' exposure to the pro-rated proportion of buy back costs not paid for under Transco's incentive arrangements. In this respect, we consider that implementation of PC 77 would remove this desirable feature of the current charging mechanism. This could introduce less stability in the overall charges levied on shippers, to the extent that they will not be protected from the uncertainty surrounding the costs of buybacks charged back to them under the current NTS SO buyback incentive arrangements. For this reason, we do not agree with Transco that PC 77 would necessarily improve overall stability of pricing and charges with respect to PC 65. Ofgem considers that it is difficult for shippers and suppliers to predict the level of charges and to set prices, where there is potential uncertainty about Transco's level of charges.

Ofgem therefore does not consider that the proposed PC 77 mechanism would better facilitate effective competition between gas shippers and gas suppliers in accordance with Transco's charging methodology objectives as set out under standard condition 4A of Transco's GT licence.

Further, Ofgem considers that an approach which, as per PC 65, offsets any excess revenue from entry capacity auction against entry capacity holders' end of day exposure to their proportion of buyback costs, better targets such excess revenue back to those users who should be refunded, without distorting shippers' bidding strategies. In particular, under the PC 65 mechanism, the TO revenue charged back to shippers is not directly linked to the prices for capacity paid at auction.

Finally Ofgem considers that Transco's proposal for a combined TO and SO commodity charge with a minimum charge of 0.0022 p/kWh, would introduce a floor price to the negativity of the TO commodity charge. It is not clear that a negative floor would be appropriate in relation to a TO commodity charge, since the TO commodity charge is simply a revenue rebalancing mechanism, and not a throughput charge by which Transco collects its allowed revenue and covers its costs.

For the reasons set out above Ofgem has decided to veto this proposal. We would therefore welcome a further consultation on a TO revenue redistribution mechanism which addresses the issues raised in this consultation, namely the need for greater certainty and stability of charges and the desirability of retaining some of the features of PC 65 or an analogous primary mechanism to deal with deviations from Transco's target revenue.