

Pricing Consultation Paper PC62
Daily System Entry Capacity Floor Prices

Summary

At present auctions of Daily Firm System Entry Capacity (DSEC) include floor prices that ensure that, on average, it would always have been a cheaper option for a shipper to purchase firm entry capacity at the relevant auction of Monthly System Entry Capacity (MSEC). That effect has been cited by a number of industry participants as a contributory factor in producing high prices at auctions of MSEC.

This proposal seeks to amend the daily floor price methodology to remove the present link between the outcome of MSEC auctions and the formulation of daily capacity floor prices. That can be achieved by amending the methodology so that determination of daily capacity floor prices will be similar to that used for calculating MSEC floor prices. Formulation of daily floor prices is different in that the floor prices will not be discounted from a level that is consistent with zero under or over recovery of formula income.

It is also proposed that Interruptible System Entry Capacity (ISEC) floor prices will be set at 0.1 times the floor prices determined for DSEC.

Introduction

Following the recent auctions of Monthly System Entry Capacity (MSEC) held in March 2000 a number of industry participants have cited the methodology for determining daily capacity floor prices as a contributory factor in the generation of high bids for MSEC capacity. In particular a ratchet effect has been noted whereby bidding up prices for MSEC results in increasing floor prices for daily capacity. The ratchet effect is created by the methodology for determination of DSEC floor prices which ensures that, on average, the floor prices will always be higher than the majority of prices paid for MSEC. This proposal is intended to remove the ratchet effect.

Proposed Methodology

1. DSEC floor price determination will be the same as the methodology for calculating MSEC floor prices except that prices will not be discounted from a level consistent with zero under or over recovery of formula income.
2. Interruptible System Entry Capacity floor prices will be set at 0.1 times the floor prices previously determined for DSEC.

Present Methodology

The floor price for firm daily capacity is set at the average of the top 50% by volume of accepted bids in ranked price order in the relevant series of MSEC auctions.

The floor price for interruptible daily capacity is set at 0.1 times the average of the top 50% by volume of accepted bids in ranked price order in the relevant series of MSEC auctions.

Discussion of the proposed Methodology

The present methodology is devised in a manner that encourages take up of monthly capacity in preference to daily firm capacity. That outcome is thought desirable because income from monthly and daily auctions contributes to differing accounts. Ideally, Transco should establish floor prices that enable shippers to choose which forms of capacity they desire most, be it monthly or daily, on efficiency grounds. That might suggest that the optimum solution would be for floor prices to be set at the same level for both monthly and daily capacity, the product in this case being identical. It can be argued that interruptible capacity floor prices should be set at a different level because the nature of the product is different. However, the interaction of a price controlled transportation income and a capacity incentive account also need to be considered.

All transportation income including that gained from auctions of monthly capacity is counted against Transco's price control formula. Income from auctions of daily capacity is counted towards the capacity incentive account. Equal floor prices may create a circumstance whereby shippers choose to expand the use of daily capacity at the expense of monthly capacity. That could lead to an under recovery of formula income and an increase in incentive income. In such a circumstance, Transco would be able to compensate for the under recovery of formula income by adjusting

transportation charges elsewhere, in accordance with the price control formula, whilst simultaneously returning a proportion of incentive income back to successful bidders for monthly capacity. The return of incentive income would be required by the terms of the capacity incentive, which has capped Transco's income from the incentive at a maximum of £5m. It also specifies that income in excess of that should be redirected on a pro rata basis to holders of MSEC. Transco does not believe that such an outcome, which could result from a change in the balance of monthly and daily capacity purchased, is desirable.

The proposal in this consultation paper seeks to mitigate against this outcome and would continue to encourage take up of monthly capacity in the first instance. However, floor prices would no longer be dependent upon the outcome of the monthly capacity auctions thus removing the potential ratchet effect described above.

The proposal sets daily floor prices at a level that, should all monthly capacity be sold at those prices, Transco would receive an income that was consistent with zero over or under recovery of its allowed transportation income. Shippers will be able to bid for monthly capacity having prior knowledge of floor prices for daily capacity so that they will have an opportunity to choose between pursuing monthly firm capacity with added information and certainty about the floor price for alternative capacity products.

Impact Analysis

The proposal would reduce floor prices at the majority of Aggregate System Entry Points (ASEPs) when compared to the floor prices generated by the auction of MSEC during March 2000. It is not certain what the impact upon end user groups will be given that floor prices are not necessarily the same as prices paid by shippers and that an interaction between monthly and daily entry capacity holdings exists in any shipper portfolio.

QUESTION FOR CONSULTATION

Transco proposes to amend the methodologies for calculating both firm and interruptible daily system entry capacity floor prices. The proposal, if not vetoed by the Director general, would be implemented from 1 October 2000. Transco would welcome respondent's views on the appropriateness of implementing the following proposals:

- 1. DSEC floor price determination will be the same as the methodology for calculating MSEC floor prices except that prices will not be discounted from a level consistent with zero under or over recovery of formula income.**
- 2. Interruptible System Entry Capacity (ISEC) floor prices will be set at 0.1 times the floor prices previously determined for DSEC.**