TRANSCO CONSULTATION REPORT ON PC78

NTS TO Commodity Charge
(NTS TO Revenue Under-Recovery)

1. Introduction

Transco has previously consulted on the introduction of a TO commodity charge as a means to deal with both over and under-recovery of TO revenue arising from fluctuations primarily within Entry Capacity auctions. Whilst Ofgem vetoed both of Transco's previous proposals, in reaching its decisions, Ofgem noted its support in principle for a TO commodity charge as a means to balance TO revenue variance. Concern was expressed in respect of the charge application, and particularly in an over-recovery situation currently covered by the PC65 mechanism[1] which targets any over-recovery to the entry capacity market.

Due to the current forecast revenue recovery position, it is not necessary to deal with over-recovery in the short term. Initially therefore we have decided to develop proposals for a TO commodity charge to address under-recovery.

In the absence of an NTS TO commodity charge to deal with potential under-recovery of TO revenue, then NTS exit capacity charges remain the only tool available to Transco in response to a forecast shortfall of NTS TO revenue. Transco considers that this arrangement is not satisfactory for reasons stated within this consultation paper and within previous consultations (PC75 and PC77)[2].

Having carefully considered industry comments made in respect of earlier TO commodity proposals, Transco published PC78, which proposed the introduction of a TO commodity charge from October 2004 as a mechanism to deal with forecast NTS TO under-recovery only. This paper sets out Transco's final proposal having considered responses to PC78.

2. Transco's Initial Proposal

PC78 sought views on a change to the transportation charging methodology with the proposed introduction of a TO commodity charge to be used in the event that a TO revenue under-recovery is forecast. Transco would continue to set NTS exit capacity charges with a view to recovering 50% of target NTS TO revenue. If the NTS TO revenue forecast were in line with, or greater than, the target for total NTS TO revenue then the NTS TO commodity charge would be zero. If the forecast NTS TO revenue were under the target level, then the NTS TO commodity charge could be adjusted accordingly.

Transco would notify changes to the NTS TO commodity charge by August (with indicative 150 day notice to the Authority by May) in respect of the 12 months commencing each October, unless exceptional circumstances dictated otherwise (these were discussed within Section 6 of the consultation paper). This process would fit well with the Annual Monthly System Entry Capacity (AMSEC)[3] auction timetable, giving time for Transco to assess the revenue position prior to giving 150 days notice of its intention 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 NTS TO commodity charge to apply to 31st March and then revert to zero from 1st April. If Transco expected to do this, this would be notified by 1st August, when the charges for October are also confirmed.

[1] PC65 Alternative Method of Funding Entry Capacity Constraint Management – July 2001 as amended by PC67 Technical Adjustment to PC65 Mechanism – September 2001.
[2] PC75 NTS TO Commodity Charge July 2002 and PC77 NTS TO Commodity Charge July 2003.
[3] Annual Monthly System Entry Capacity auction held in February of each year.

For the avoidance of doubt, this proposal did not deal with NTS TO revenue that is forecast to be above the target level. In a situation where over-recovery results from entry capacity auctions then the PC65 mechanism remains the primary TO revenue adjustment tool available to Transco. As a mechanism for dealing with under-recovery the NTS TO commodity charge would only be positive.

3. Summary of Responses

Comments and views were invited on the issues raised within this consultation paper.

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

Shippers & Suppliers	
BG Gas Services Limited	BG
British Gas Trading	BGT
ChevronTexaco	CT
ConocoPhillips UK Limited	CP
EDF Energy plc	EDF
Eni Group	Eni
ExxonMobil Gas Marketing Europe Limited	EM
Powergen UK plc	POW
RWEInnogy (npower)	RWE
Scottish & Southern Energy	SSE
Scottish Power	SP
Shell Gas Direct Limited	SGD
Statoil UK Limited	STA
Total Exploration & Production UK plc	TEP
Total Gas & Power Limited	TGP
Other Interested Parties	
Association of Electricity Producers	AEP
Corus UK Ltd	COR

Ten respondents expressed support for the introduction of a TO commodity charge to balance TO revenue in the event that TO revenue was forecast to be below the target level. There was no consensus amongst these ten of the appropriate TO commodity charge base, five (TGP, TEP, EM, CT, SP) supported the charge being levied on entry and exit flows, and five (BGT, EDF, SSE, POW, AEP) supported the proposal if a charge were levied on entry flows only. One respondent (EM) qualified its support to the extent that any entry flow should be in the context of the flow against holdings of daily entry capacity (DSEC & DISEC), and providing Transco committed to further review its (EM) concerns relating to commodity charging on entry flows.

Seven respondents (BG, RWE, CP, Eni, SGD, STA, COR) were against the introduction of a TO commodity charge.

Detailed Responses:

TO Revenue Entry / Exit Split

Four respondents (SSE, RWE, POW, AEP) considered that application of a TO commodity charge applied across both entry and exit flows would distort the aim of recovering TO revenue on a 50:50 split basis between entry and exit. SSE stated that “In an attempt to ensure cost reflective and efficient investment signals are provided, it is important that TO costs are targeted at the appropriate sector of the market and not smeared across the entire market.”.

Three respondents (SSE, AEP, SGD) noted the apparent inconsistency of the under-recovery TO commodity proposal with the current PC65 methodology which addresses forecast TO revenue over-recovery. PC65 targets shippers at entry rather than both entry and exit and remains the primary tool available to Transco to adjust any TO over-recovery of revenue.

Two respondents (AEP, RWE) were concerned at the possibility that gas bought at, or indexed to, the NBP may already include an assumption of the cost of entry capacity. A TO commodity charge levied against exit flows could undermine this position.

Three respondents (CT, CP, BG) noted that shippers at exit had benefited from windfall gains in the past where revenue in previous entry capacity auctions had been previously over-recovered. CT added that the “Transco proposal appears to be reasonable compared with the alternative of loading charges onto gas producers at the NTS import terminals”. One respondent (EM) suggested that more detailed consideration be given to the possible distortionary effects of levying the TO commodity charge on entry.

BG and CP requested clarification of the treatment of storage in respect of NTS commodity charging.

Transco’s Response

Transco aims to recover 50% of its NTS TO revenue through NTS exit capacity charges, assuming that the other 50% will be recovered from NTS entry capacity auctions. In practice, auctions will rarely deliver 50% of the NTS TO target revenue. A number of respondents to this consultation paper have argued that Transco’s proposed approach of levying a TO commodity charge across shippers entry and exit flows will unduly distort the aim of maintaining the 50:50 split of TO revenue recovered between entry and exit.

On balance, Transco is swayed by those respondents that argue a TO commodity charge should solely be levied against shipper entry flows. Under-recovery would normally be caused by the outcome of entry capacity auctions, therefore by levying the TO commodity charge on entry flows only, the sector causing the variations would be better targeted.

While auction outcomes are likely to be the primary driver for revenue under-recovery, under-recovery may also arise from the application of NTS exit charges. We would propose to exclude under-recovery arising from NTS exit charging when setting the NTS TO commodity charge. Transco will take account of ongoing developments to the exit capacity regime, and is considering bringing forward further proposals to deal with under-recovery of NTS TO revenue that may arise from NTS exit charging. This review would also consider whether it was appropriate to continue levying the proposed TO commodity charge solely on entry flows.

A further benefit of a TO commodity charge for use in the event of an under-recovery, and levied solely on shipper entry flows, would be the symmetry with the PC65 mechanism for TO revenue over-recovery, which is also applied to entry shippers.

The proposed TO commodity charge would not apply to storage flows at this time. Transco intends, in the near future, to consult on transportation charge arrangements at storage points connected to its system.

Security of Supply

Five respondents (BG, EM, CT, CP, Eni) raised security of supply concerns. These centred on the detrimental impact that a TO commodity charge, levied at entry, might have on the development of future additional gas supplies, and within a climate where the U.K. is set to become a net importer of gas. Eni suggest this charge represents an additional tax on the offshore industry which compounds the already high entry capacity charges at St Fergus and Teesside.

Transco Response

Transco does not share the view of the respondents that replied on this issue that levying a TO commodity charge at entry would impact U.K. security of supply. The proposed TO commodity charge would not affect the total level of charges levied by Transco. Consequently the prices paid by the end consumers and the demand for gas will be unchanged. We do not believe a common TO commodity charge applied across flows at all entry points will impact on the development of new gas supplies generally, or on the relative dynamics between different sources of potential new supply.

Target Entry Flows Against Daily Entry Capacity (DSEC & DISEC)

EM suggest that where a TO commodity charge is applied across entry flows, this should only be in respect of that entry flow recorded against daily entry capacity (DSEC & DISEC). The respondent noted that "current regulations to commit to long term capacity booking to ensure transmission investment can be implemented for entry of competing new supplies, may be exposed over time to pay increasingly significant TO commodity charges over and above the capacity charges already committed to secure new investment".

Transco Response

NTS entry capacity is acquired by shippers through long and shorter-term auction processes. Any forecast TO revenue variance to the entry target level would be as a consequence of shipper behaviour within long and short-term entry capacity auctions. Therefore, Transco considers it appropriate that a TO commodity charge is levied across all entry flows.

NTS Exit Capacity

Three respondents (EDF, POW, AEP, SSE) shared Transco's concern that the use of NTS exit capacity charges to balance TO revenue could create adverse impacts in respect of the NTS exit capacity incentive, locational exit signals, and the firm / interruptible transportation charge differential.

Retention of NTS Exit capacity charges as the means to balance TO revenue variance was favoured by two respondents (Eni, CP). STA suggest that the full effects of the entry capacity auctions on TO revenue should be considered over a reasonable period of time before developing more robust solutions to promote longevity of the transportation charge methodology.

COR consider that retention of NTS exit capacity charges as the means to balance TO revenue variance would have the advantage of increasing the firm / interruptible transportation charge differential. The respondent considered this would address concerns relating to security of supply by encouraging more interruptible supply contracts.

Transco's Response

Transco remains of the view that there is considerable merit in changing the current transportation methodology to avoid numerous distortionary impacts, as described within the consultation paper, associated with the general use of NTS exit capacity charges for TO revenue balancing purposes. Only two respondents challenged this basic premise for change, with a third suggesting more time be given to understanding the effects of entry capacity auctions before moving away from the current approach.

Transco does not agree with the respondent that an increased firm / interruptible transportation charge differential is justification for retention of the current transportation charge methodology. This issue has been debated at great length within the NTS exit capacity Network Code workstream.

Charge Setting

The early publication of indicative rates was welcomed by one respondent (AEP). SSE sought clarity on whether the 150 day notice would be issued to shippers in addition to the GT Licence requirement to provide notice to the Authority.

Six respondents (POW, SSE, SP, TEP, STA, RWE) welcomed the annual approach to TO commodity charge adjustment.

It was suggested by SGD that a pricing consultation be raised to address the issue of transportation charge stability. EDF suggested that revenue forecast transparency should be the subject of a consultation.

Transco's Response

Transco is required, under its GT Licence, to provide the Authority with a 150 day notice of its intention to change transportation charges. Historically, Transco has made this notice available to the industry and we see no reason to change this approach.

Transco continues to consider the issues of charge stability and predictability as part of any proposed amendment to its transportation charging methodology. The issue of stability and predictability was discussed most recently within Pricing Discussion paper PD17[4]. This current proposal is sensitive to the concerns raised by respondents within that discussion paper, and as part of this proposal, Transco describes the process by which it would publish changes to the TO commodity charge in respect of the 12 month period commencing each October. We would only consider departing from this process where the forecast level of under-recovery was so great that an earlier (than October) adjustment to the TO commodity charge was preferable in order to limit the level of the charge required. This would only be considered annually following the outcome of the AMSEC auction and before setting the charges to apply from October, where the level of entry capacity revenue recovery is forecast to be more than 30% below the target given the current level of the TO commodity charge. A change to the TO commodity charge will not be made earlier than October where a forecast under-recovery of auction revenue is less than 30% below the target level.

In light of the outcome of this consultation paper, and previous comments to PD17, Transco is considering the benefits or raising a pricing discussion paper to seek views from industry participants on the issues of general transportation charge predictability and stability.

[4] PD17 Setting of NTS Transportation Charges – January 2003.

NTS TO Revenue Above The Target Level

SGD thought that the issues of forecast over and under-recovery of TO revenue should be addressed at the same time. Whilst expecting Transco to issue a pricing consultation to address TO revenue over-recovery, BGT did not consider this issue to be of such significance that it should obstruct implementation of a TO commodity charge to address under-recovery.

Two respondents (SGD, EDF) noted that Transco's GT Licence obligations in respect of TO revenue over-recovery could potentially encourage smaller, more frequent, changes to transportation charges in order that Transco avoid a breach of Licence parameters in respect of TO revenue recovery.

Transco's Response

As noted previously, the current position is such that there is no requirement to address over-recovery of revenue in the short term. We also believe this modified proposal is more consistent with the current arrangements for dealing with over-recovery, however, Transco intends, at a later date, to consult on NTS TO revenue over-recovery, including a review of the existing PC65 mechanism.

Entry Capacity Auctions

Two respondents (SP, BG) expressed a view that entry capacity auction rules should be addressed rather than introducing a transportation charge mechanism to deal with any variance. COR was of the view that entry auctions should be discontinued in favour of Ofgem administered transportation charges at entry, or failing this, that an entry capacity "clawback" charge mechanism be introduced in the event of a TO revenue under-recovery.

Transco's Response

The form of entry capacity charging was not the subject of this pricing consultation.

However, Transco would note that entry capacity auctions, by their nature, will deliver a TO revenue outcome that is not predictable, and indeed that a variance to target revenue levels should be expected. The extent and direction of any auction revenue variance is the result of shipper bidding strategy within the auction. Transco believes that the possibility of a TO revenue variance can never be fully removed from the auction process and consequently there remains a need for a TO charge that can be used as a revenue balancing tool.

NTS Optional Commodity Tariff

Four respondents commented on the NTS optional commodity tariff. Three of these (EDF, RWE, AEP) considered that the optional tariff should be an alternative to the combined SO and TO commodity tariff. SP suggested that the TO commodity charge should be levied in addition to the optional commodity tariff.

Transco's Response

Transco is not proposing as part of this process to modify the optional commodity charge, and there is considerable support for this approach from respondents. This optional charge is proposed to remain as an alternative charge to the combined TO and SO commodity charge.

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". Transco is considering a review of the NTS SO commodity charging methodology, including the NTS optional commodity tariff, to address these issues.

NTS TO commodity Charge Implementation Date

Seven respondents (EDF, SSE, POW, AEP, SP, TEP, TGP) agreed that, if not vetoed, the TO commodity charge should be implemented for 1st October. Generally this was for the reason of charge predictability. BGT suggest that, on an enduring basis, the TO commodity charge be set for a full 12 month period from April with a small adjustment as required in October, but initial implementation should be for October 2004.

Transco requested comment, as part of this consultation, about the trade-off between the timing of the adjustment to the TO commodity charge and the level of the charge. All eight respondents that expressed a view stated their support for a charge levied to a stricter timetable rather than a short notice adjustment to avoid a later larger charge.

Transco's Response

Of those respondents that expressed an opinion, Transco notes that the majority support implementation for 1st October and that in future years the charge should be changed on the same date to improve charge predictability and stability. As noted in the consultation paper, Transco considers that publishing changes to the NTS TO commodity charge annually in respect of the 12 months commencing each October is consistent with the Annual Monthly System Entry Capacity (AMSEC) auction timetable.

Transco notes the view of respondents that more notice of a charge adjustment, and to a defined timetable, is preferred to a short notice adjustment aimed at reducing the extent of a later adjustment.

4. Conclusion

Transco proposes to implement a TO commodity charge largely as described within consultation paper PC78. As part of the consultation, we invited comment on whether the proposed TO commodity charge should be levied on a split between exit and entry flows, fully on either exit or entry flows, or applied to any alternative charging base. Transco is swayed by those respondents that argue the TO commodity charge should be levied solely on entry flows as the driver for under-recovery is primarily entry auction revenue. Accordingly, the final proposal has been amended such that the proposed TO commodity charge would be levied solely against entry flows. In cases of under-recovery arising from the application of NTS exit capacity charging, NTS exit capacity charges may be adjusted accordingly. However, Transco is considering bringing forward further proposals to deal with under-recovery of NTS TO revenue that may arise from NTS exit charging. This review would consider whether it was appropriate to continue levying the proposed TO commodity charge solely on entry flows.

In raising the final proposal, Transco has been sensitive to comments received to this, and previous, consultation papers in respect of transportation charge stability and predictability. We also note those comments that charges should target that sector that gave rise to the revenue variance. We consider this proposal to be consistent with our relevant GT Licence objectives in respect of the transportation charging methodology. Specifically, the proposed transportation charge methodology would facilitate competition and improve cost reflectivity because:

- charges would be more predictable and stable across the year;
- charges would be targeted to those parties giving rise to the revenue variance;
- exit charges would be protected from variations in income from entry capacity auctions;
- the proposal is consistent with existing tools available to Transco for the adjustment of TO revenue over-recovery.

5. Final Proposal

Transco therefore proposes:

- That an NTS TO commodity charge be introduced from October 2004, additional to the NTS SO commodity charge, which would be used to adjust the level of NTS TO revenue if there is forecast to be a material under-recovery of NTS TO revenue against the maximum allowed NTS TO revenue, that does not arise from NTS exit charging, following the AMSEC auctions;

- That the NTS TO commodity charge will be set to have a zero rate where forecast entry capacity auction revenue is in line with, or greater than, target revenue;

- That the NTS TO commodity charge should solely be levied on entry flows;

- That changes to the NTS TO commodity charge would be notified by August in respect of the 12 months commencing each October, and that Transco would only consider departing from this process if there is a greater than 30% under-recovery of forecast auction revenue given the current level of the TO commodity charge;

- That the Optional NTS Commodity Tariff remains available as an alternative to the combined NTS SO and NTS TO commodity charge;

- That TO commodity will not be levied on storage flows.