March 2001

TRANSCO DISCUSION REPORT ON PD13

NTS Auction Over-Recovery

1. Transco's Initial Discussion

In PD13 Transco invited views on a number of options with regard to how the over recovery implied by the April to September 2001 monthly entry capacity auctions might be avoided within the Transportation Charging Methodology. Views were invited on eight main options, this paper summarises these views and sets out Transco's response to them.

2. Summary

There were 26 responses to the discussion paper:

Shippers & Suppliers	
Alliance Gas	AG
Aquila	AQU
BP Gas Marketing	BPG
British Gas Trading	BGT
Chevron	CHE
CINergy	CIN
Conoco	CON
Dynegy	DYN
Enron	ENR
Enterprise Oil	ENT
Exxon Mobil Gas Marketing	MOB
Innogy	INN
Marathon Oil	MAR
Norsk Hydro	NOR
Northern Electric	NE
Powergen	PG
Scottish & Southern Energy	SSE
Texaco	TEX
Total Fina Elf	TOT
TXU Europe Energy Trading	TXU
Yorkshire Energy	YE
Other Interested Parties	
Association of Electricity Producers	AEP
Chemical Industries Association	CIA
Corus	COR
Terra Nitrogen	TER
Transco LNG & Storage	LNG

A number of these respondents requested that their views should remain confidential, as a result all references to these respondents have been replaced by the abbreviation (XX).

- Eleven respondents expressed a preference for scaling accepted bids. (MAR TEX TER XX TOT CIA XX CON MOB AG CHE)
- Four respondents expressed a preference for implementation of the present methodology. (BGT AQ NE XX)
- Three respondents expressed a preference for a one off adjustment. (SSE BPG XX)
- Two respondents expressed a preference for each of an entry commodity rebate (CHE ENT) and the creation of an investment fund (LNG DYN).
- One respondent expressed a preference for a reduction in NTS exit capacity charges (YE).
- Three respondents expressed a preference for a solution that included some combination of carry excess forward, reduce NTS exit capacity charges, fund capacity buy backs, create an investment fund and introduce an entry commodity rebate. (AEP XX CIN).

3. NTS BASED OPTIONS

3.1 Carry Excess Revenue Forward

This option was not supported by any respondent. However, one (AEP) thought that it might form part of a multiple approach. A number of respondents rejected the option on the basis of possible distribution effects (a) between the present and future holders of MSEC (TEX TER CON SSE XX) and (b) between shippers with varying positions upstream and downstream of the NBP (CIN MOB).

The option was also rejected for practical reasons by a number of respondents (SSE LNG CHE XX BGT CON CIA XX). Given uncertainty surrounding future auction outcomes and the NTS commodity charge bottom stop, it was believed that it could take many years before the present over recovery was returned.

The respondent (AEP) that favoured this option as part of a package of measures believed that it had the advantage of ring fencing the adjustment within the NTS tier of transportation charges. Although it was recognised that the timing of revenue returns may have distributional impacts the view was expressed that these would be minor in comparison to the impacts resulting from other methodologies.

Transco's Response

Transco agrees with respondents that this option is inappropriate in the present circumstances. If all future NTS auctions were to recover the target revenue, it would take almost three years for adjustments to the NTS commodity charge to remove the potential over recovery. Transco also recognises that the option might have distributional impacts as shipper portfolios change over time. As regards distributional effects between those with differing positions upstream and downstream of the NBP, Transco believes that these would depend on how prices at all stages of the gas chain adjusted to various influences.

3.2 Reduce NTS Exit Charges

This option was supported by one respondent (YE) on the basis that it was simple and ring fenced the adjustment within the NTS tier of transportation charges. Another respondent (AEP) also saw merit in the approach as part of a package of measures. A further respondent (CIA) felt it was very much a second best option, its only benefit being that it was ring fenced.

Many respondents rejected the option feeling that it would severely disadvantage interruptible customers (CIN SSE XX BGT LNG XX XX), other distributional impacts would exist between present and future MSEC holders (TEX SSE) and between shippers with differing positions upstream and downstream of the NBP (CHE CON XX). Other respondents that partially supported the option (AEP CIA) recognised the possibility of severe locational and interruptible as opposed to firm customer impacts.

Two respondents (BGT LNG) expressed the fear that this option may have serious secondary implications with regard to entry capacity credits paid at constrained LNG sites, the upcoming Ofgem review of the exit capacity regime, certain Transco penalties, such as failure to interrupt, and the behaviour of power generators following the introduction of New Electricity Trading Arrangements (NETA).

Transco's Response

As with the previous option, Transco agrees with the majority of respondents that such an approach would not be appropriate in the present circumstances. To remove the potential over recovery exit charges would have to be held at zero for two years.

3.3 Fund Capacity Buy Backs

This option was partially supported by three respondents (AEP CIN XX) each of which said that it should only account for a minority of the excess revenue. However, one (CIN) felt that this should only be short term and that there were better ways to fund buy back costs in the longer run. Another (XX) supported the option on the basis that the value shippers put on capacity includes the risk of buy back.

Respondents rejected this option not only on the basis of limited scope (SSE XX CHE CON) but also because they feared it could lead to gaming by shippers in order to secure high buy back prices (BGT CON). The main reason for rejecting the option, however, was the belief that it was in effect a subsidy to Transco and meant that it could avoid its obligations under the capacity incentive regime (TEX TER SSE MOB CHE CON CIA). One respondent that supported this as a partial solution (AEP) also expressed similar fears regarding shipper gaming and Transco's incentives.

A further respondent (LNG) wondered how any monies remaining would be distributed after all buy backs had been funded.

Transco's Response

Transco agrees with the majority of respondents that this is not an attractive option in the present circumstances.

3.4 Entry Commodity Rebate

This approach was supported by two respondents (ENT CHE), although the latter stated that it should be terminal specific and limited to MSEC holdings only. A third respondent (XX) supported the option as the major element of a multiple approach. Two respondents stated that they would be satisfied with the approach should their preference not be implemented (MAR NOR). Again, the latter stated that implementation should be terminal specific.

Two respondents (XX CON) expressed the view that, while not practical in the short term, this approach should form the basis of any longer term adjustment mechanism. Another two (NE INN) felt that the mechanism should be looked at in the future but that there remained concerns regarding possible impacts.

Views expressed in favour of the mechanism were that it focused the solution on the problem area (ENT CON XX) and that, since it was targeted on usage, it would discourage hoarding and over buying of capacity (XX XX).

The major objection to this approach was that it was similar to scaling accepted bids such that it destroyed the pay as you bid principle that underpins the auction regime (SSE BGT LNG AEP). Three shippers felt that the approach was too complex and so could not be implemented within acceptable timescales (TEX SSE CIN); indeed one of its advocates (ENT) expressed its appreciation of the possible implementation difficulties. Three respondents (CIN BGT INN) also feared that the mechanism would encourage excessive flows of gas, thereby increasing the likelihood of capacity buy backs being required. Finally two respondents (TER CIA) stated that negative charges simply defied logic.

Transco's Response

Transco accepts that there are a number of operational and regulatory reasons why this approach could not easily be implemented quickly. Since there is no existing charge item based on UDQIs, a new charge category would need to be established with clear business rules, and this would involve modifications to existing IT systems. Transco is also concerned that a negative charge is potentially in conflict with existing elements of the Network Code and Condition 9c of the PGT Licence, and any such conflicts may take time to resolve.

In the longer term, however, Transco agrees that such an approach could be considered as a possible means of ensuring that auctions do not result in unacceptable deviations from the level of recovery permitted under the price control.

3.5 Creation of an Investment Fund

Two respondents (LNG DYN) supported this option, the former because it believed that it would encourage more realistic bidding behaviour, and the latter because it believed the auctions had demonstrated clear investment signals that needed to be followed in order to facilitate future North Sea developments. Two respondents (CIN AEP) expressed support for the approach as part of a package of measures, the former stating its belief that investment was needed to remove the constraints that lead to excess revenue. Another four respondents (ENT AG CHE XX) expressed the view that, given the correct rules, they would be favourable to at least a proportion of over recovery being used to fund suitable investment.

The approach was rejected by three respondents (MOB XX INN) on the basis that the present auction regime had too short a time horizon on which to base long term investment and that the anticipated constraints may be transitory. In a similar vein one respondent (XX) feared the approach might lead to the creation of redundant assets and future under recovery.

Three respondents (TER SSE CIA) expressed the view that the approach amounted to a Transco subsidy. Two respondents (TEX CON) felt that there were distributional impacts between current and future MSEC holders, as well as questions surrounding future ownership and access. One respondent (BGT) stated that the proposal confused the means by which the allowed revenue was established and the charging methodology by which this revenue was raised.

Transco's Response

Transco agrees with the majority of respondents that this approach is not appropriate in the present circumstances. Transco also agrees that the present auction regime is such that outcomes may not provide a robust signal as to the long-term demand for entry capacity in any particular area of the National Transmission System. Transco believes that the framework for investment signals and funding should be addressed as part of its Periodic Review.

3.6 Scaling Accepted Bids

This approach was supported by eleven respondents, (MAR TEX TER XX TOT CIA XX CON MOB AG CHE). The main theme expressed by supporters was that the approach focused adjustment onto the area of over recovery. This meant that there were minimal distributional effects between various shippers or groups of customer. Two respondents were, however, conditional in their support (CON CHE). The former stated that this should only be a short term approach, while the latter stated that scaling should be on an absolute amount basis as this would penalise those that bid highest. Another respondent (XX) stated that it was not opposed to the approach but felt that it did not have the advantages of their preferred option, an entry commodity rebate, as it did not encourage usage of capacity holdings.

The main disadvantage of this approach expressed by a number of respondents (SSE BGT LNG AEP DYN) was the belief that the approach would fundamentally undermine the auction system itself. One respondent (MAR), however, criticised this argument on two grounds -firstly that any over bidding could not be affected by the application of this approach and, secondly, if Transco argued that such a policy was tantamount to a return to administered charges, then surely this could be said about any adjustment mechanism. A further respondent (TOT) accepted the validity of the argument but argued that scaling was a pragmatic one off approach that should be followed by radical overhaul of the auction process.

Two respondents (XX CHE) suggested that the approach potentially created inequality because some failed auction bids would be higher than accepted but scaled bids.

Transco's Response

Transco acknowledges that this is the favoured option among respondents, but that the option also tends to polarise opinion. Whilst any adjustment focused on adjusting bids 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. At this stage, and given the split of opinions, Transco is not convinced that it would be appropriate to adopt this option.

4. SYSTEM WIDE OPTIONS

4.1 Maintain the Present Methodology

This option was supported by four respondents, (BGT AQ NE XX) on the basis that it was consistent with Transco's present Transportation Charging Methodology. It was felt that post auction adjustments to the methodology could only lead to uncertainty within the supply chain. A fifth respondent (INN) was of the view that either this option or a one off adjustment was the best approach, but that more discussion on each was required before it could express a definitive view.

A number of respondents (TEX XX MOB AEP SSE LNG CIN CHE AG CIA) rejected the approach on the basis of unacceptable distributional effects, for example between future and present holders of MSEC, between shippers with differing positions upstream and downstream of the NBP and between shippers with various customer portfolios.

Three respondents (CIN SSE MOB) stated their opinion that the approach was not cost reflective, one of whom (MOB) believed that it ran contrary to the possible NTS/LDZ split within Transco's price control. There were also four respondents (CIN SSE LNG CON) that felt that the approach would lead to unacceptable instability in the level of transportation charges. Two respondents (CIN SSE) believed that the stability and cost reflectivity problems were so serious as to potentially put Transco in breach of its licence obligations. Three respondents (CIN TER LNG) further expressed the view that the timing of revenue return would have undesirable cash flow implications for shippers.

One respondent (BGT) that favoured this approach dealt with a number of these issues. It argued that the mechanism was cost reflective as all transportation charges were scaled, any windfall gain to Transco as a result of cash flow timings would be dealt with in the subsequent formula period and that instability of charges could be reduced if adjustment was implemented over the period until April 2002. Another respondent (AQ) argued that because the results of the auctions had led to increases in the NBP price of gas, it was only fair that the majority of revenue should be returned via transportation charges that are effective downstream of the NBP.

Transco's Response

Transco agrees with the majority of respondents that this is not an ideal way of removing the potential over-recovery. However, it also agrees that retrospective changes to the charging methodology may be seen as introducing inappropriate risk into the gas supply chain.

4.2 One Off Adjustment

This option was favoured by three respondents (SSE BPG XX) another (INN) was of the view that either this option or the present mechanism was the favoured option but that more discussion on each was required before it could express a definitive view. Support was based on the apparent simplicity of the mechanism and the belief that it would be capable of returning all the excess revenue within the period. Two respondents (INN SSE) were of the view that basing the rebate on AQ or SOQ would have a very similar effect to that of the present mechanism. One respondent (XX) believed that the adjustment should be on the basis of actual throughput over the period, while another (BPG) thought it should be linked to MSEC holdings, arguing that this was not equivalent to scaling accepted bids. This approach was viewed as acceptable to one respondent (MAR) which, as a whole, did not favour this option.

Reasons for opposition to this approach were similar to those relating to the present methodology. Three respondents (TEX CIN XX) felt there would be undesirable distributional effects, while another (CIN) felt that it would not be cost reflective and would have cash flow implications. Two respondents (AG BGT) opposed the option on the basis that it was too complex and hence costly to implement.

Transco's Response

Transco notes, as for other options, the divided opinions about the merits of this approach. Transco also notes the view that the scope and outcomes of this mechanism could be very similar to applying the present transportation charging methodology. Given this and the potential practical issues surrounding implementation of a new approach, Transco does not believe that it is an acceptable approach in the present circumstances.

5. Transco's Proposal

Transco welcomes the level of interest in the discussion paper. It is clear, however, that opinion is divided about both how best to deal with the potential over-recovery following the latest round of NTS auctions and the ongoing conflict between revenues raised via an auction and an independently set revenue limit.

Of the options raised, scaling accepted bids attracted more support than any other. However, this option also attracted strong opposition. This polarisation of views may be regarded to some extent as reflecting the conflict between auctions and a price control. In Transco's opinion, it would not be appropriate to scale bids since this would fundamentally undermine the commercial arrangements and incentives embedded in the auction process. Nevertheless, Transco also recognises that it could be similarly argued that reducing other transportation charges could be seen as undermining the basis on which they are set and the economic signals they provide. While this may be undesirable, compliance with the price control is essential.

Transco therefore believes it is appropriate to rely on the existing arrangements within its transportation charging methodology and to reduce its major transportation charges in order to avoid over-recovery relative to the price control in the forthcoming formula year.

Transco therefore proposes a 15% reduction of LDZ Capacity, LDZ Commodity, NTS Exit, and Customer charges with effect from 1 June 2001. By application of the charging methodology, reserve prices for future auctions of NTS entry capacity will also be reduced by 15%.