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Shippers, Transco and other Interested
Parties

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Dear Colleague,

Modification Proposal 0626 'Structure of the NTS SO Commodity Charge'

Transco raised modification proposal 0626 '*Structure of the NTS SO Commodity Charge*' on 14 April 2003.

Ofgem has carefully considered the issues raised in this proposal and has decided to direct Transco to implement this proposal because we consider that it better facilitates the relevant objectives of Transco's network code, as set out under standard condition 9 of Transco's Gas Transporter (GT) licence.

In making this decision Ofgem has taken into account Transco's obligations under its GT licence, our wider statutory duties and all relevant facts.

We have set out below the reasons for our decision to direct Transco to implement this modification proposal.

Background

The modifications introduced into Transco's GT licence in September 2002 (effective April 2002) introduced the separation of the regulation of Transco's role and accounting functions as Transmission asset owner (TO), where it builds and maintains the network, from its role as National Transmission System (NTS) system operator (SO) where it determines the need for additional capacity and the day-to-day operation of the system. As a result, Transco recovers its allowed TO revenue through the sale of entry capacity and exit capacity charges. In addition, Transco levies a throughput based NTS SO Commodity charge through which it recovers, amongst other things, allowed SO incentive revenues. A further discussion of this charge appears below.

Pricing Consultation 70 'NTS system operation transportation charges'

In January 2002, Ofgem decided not to veto Pricing Consultation (PC) 70, '*NTS System Operation Transportation Charges'*. PC 70 replaced the NTS standard commodity charge with an SO commodity charge, which has applied since 1 April 2002. The SO commodity charge is currently levied on all gas transported on the NTS, based on exit flows (other than flows to storage sites). It recovers Transco's system balancing costs, SO internal costs and is adjusted to address payments or revenues arising from Transco's proposed SO incentive schemes. PC 70 also provided that the SO commodity charge should be applied to NTS flows into gas storage sites. In our response to PC 70, Ofgem stated that we considered it would be more appropriate if the SO commodity charge were levied on both entry and exit flows since the costs borne by Transco, as system operator, can either be caused by the patterns of gas entering or exiting the system. Accordingly, splitting the charge between entry and exit would allow for better cost targeting. The basis on which the SO commodity charge would be applied to gas storage sites is currently under review.

Pricing Consultation 73 'Structure of the NTS SO commodity charge'

PC 73 was raised by Transco in April 2002 and proposed that the same level of SO commodity charge should be applied to both entry and exit flows such that approximately 50 per cent of revenue collected is obtained from entry and exit respectively. At that time Transco considered that further developing the SO commodity charge in this way would be regarded as a more cost reflective charging methodology and would ensure that all shippers using the NTS would contribute directly to the revenue raised through commodity charges.

A number of respondents supported Transco's pricing proposal. They considered that the proposal would lead to a more cost reflective charging structure and expected that the change would have a close to neutral effect on the gas price. Respondents considered that shippers who offtake gas from the NTS are not the only physical users who contribute to the costs of running the NTS and as such should not solely be required to pay for these costs.

A number of respondents considered that the proposal would impact heavily on the upstream industry, including those producer-shippers who deliver gas to the NBP only and on offshore producers who sell gas at the beach. Respondents considered that PC 73 may push some producers to trade at the beach in order to avoid the SO commodity charge.

Ofgem did not veto PC 73. We reiterated our views that this approach would be more cost reflective and we also stated that this approach would be more consistent with the balancing services use of system (BSUoS) charges levied under the wholesale electricity trading regime. BSUoS charges are recovered from both demand and generation system users based on half hourly electricity flows into and out of National Grid Company's transmission system.

Ofgem recognised at that time that the change in charging methodology may have implications for shippers with existing contracts, system and invoice changes. Ofgem acknowledged that Transco had therefore revised its original pricing consultation proposal to allow for the SO commodity charge to be based upon entry and exit flows from 1 October 2003, thereby allowing a period of 15 months for any associated contracts to be renegotiated.

Applicability of charge to storage sites

The current SO commodity charge is not applicable to storage facility gas flows (save for own use gas). As stated in Ofgem's February 2003 decision letter '*Application of SO commodity charge to storage facilities*[1]' Ofgem continues to believe that, in principle, storage flows should not be excluded from the application of the SO commodity charge. However, the development of an appropriate methodology for recovering the SO commodity charge from storage facilities is still being considered by Transco.

NTS Optional Commodity Charge

Under the current arrangements, a shipper can apply for the NTS optional commodity rate in respect of its offtakes from any system exit points. The optional commodity tariff enables the shipper to obtain a discount from the standard SO commodity charge. The short haul tariff was intended to ensure that Transco's charges better reflected its costs and did not lead to inefficient investment decisions by shippers to build bypass pipelines close to entry terminals.

In raising PC70, Transco consulted upon whether to retain the shorthaul tariff in the form of a discounted NTS SO commodity charge. Following this consultation, Transco concluded that it should retain the tariff as a pragmatic method of helping to avoid uneconomic bypass. In its decision letter, Ofgem called on Transco to review, as a matter of urgency, the extent to which the short-haul tariff was cost reflective under the terms of Transco's GT licence (standard condition 4A). In its decision letter for modification proposal 0600 '*Amendment to Optional National Transmission System (NTS) Commodity Rate requirements to input gas at the local entry point'* Ofgem reiterated this view and the optional commodity rate remains subject to review.

The proposal

The proposal provides for the NTS SO commodity charge to be calculated by applying a revised SO commodity charge rate to both daily input and offtake quantities.

The proposed charges would, with the exception of the storage connection points, apply to all NTS exit and entry points. Transco proposed that there should be no change to the existing approach in respect of storage connection points, such that the NTS SO commodity charge would apply solely to storage sites in relation to exit flows associated with own-use gas consumed at the respective storage facility. Transco suggested that the extension of the SO commodity charge to other flows associated with storage connection points would be determined subsequently to satisfy the requirements of the PC 70 pricing methodology. Transco envisaged that this proposal would enable implementation of charges in accordance with the methodology established within PC 73.

In its final modification report for modification proposal 0626, Transco proposed a new timetable for invoicing in order to accommodate the new structure of the charge. It proposed that NTS exit commodity charges are invoiced after close out of user daily quantity outputs (UDQOs), entry commodity charges will be invoiced after close out of user daily quantity

[1] See modification proposals 532, '*Application of SO commodity charges to all NTS loads'*, 545 '*Application of SO commodity charges to storage facilities'* and 547 '*Reconciled SO commodity charges at storage facilities'*

inputs (UDQIs) and the NTS optional commodity charge will be invoiced following validation of the UDQO and UDQI data derived from the entry and exit invoices.

Respondents' views

There were 12 responses to this proposal. The majority of respondents were in support of this proposal. A small number of respondents qualified their support on the grounds that it would have been preferable for Transco to introduce changes relating to storage flows and a TO commodity charge concurrent with this proposal.

Implementation of PC 73

The majority of respondents who supported the proposal considered that it would formalise PC 73. Respondents reiterated the views expressed in PC 73. A number of respondents suggested that an equal distribution of the SO commodity charge across all parties active in buying and selling at the beach or at the notional balancing point (NBP) will benefit the competitiveness of the gas regime. Respondents considered that the charging methodology as set out in PC 73 and in the modification proposal 0626 would result in more cost reflective charging.

One respondent noted that any further delay in the implementation of PC 73's methodology beyond 1 October 2003 could result in certain industry players incurring additional contract and system costs. The respondent further suggested that there would be greater uncertainty for the industry whenever a pricing consultation decision is made if Transco's recommendations deviate from the original implementation date thereafter. Some respondents commented that the proposal would better align gas and electricity charging arrangements.

Application to storage flows

Respondents noted that under this proposal there would still be no application of the NTS SO commodity charge to storage sites, except in relation to own use gas. Several respondents expressed disappointment at the lack of development in this area. A number of respondents to this proposal considered that storage sites should be exempt from a commodity charge due to the service and benefits that storage users supply, at low cost, to balance the NTS.

Implications for offshore producers

Respondents who were against the proposal reiterated their original concerns with PC 73. They commented that the charging structure may impact on the pricing structure and trading at NBP, by increasing the costs of delivering gas to the NBP.

Respondents suggested that the increased costs to producers by imposing a charge upon entry flows would have a negative affect on the economics of investing and developing smaller fields in the UKCS with consequential impacts upon security of supply. One respondent suggested that the application of the SO commodity charge to storage flows may discourage oil and gas companies from investing in the UK North Sea, potentially exacerbating the gas shortages which are anticipated to occur in the UK from next year.

One respondent commented that it did not concur with the view that the additional costs would be passed through to NBP prices. This respondent also commented that substantial quantities of gas bought and sold under contracts that extend beyond October 2003 and sellers will be left bearing increased costs.

Volatility of charges

A small number of respondents were concerned that SO commodity charges could be volatile and that such volatility could affect liquidity in the market.

Respondents further suggested that if the SO commodity charge was to be implemented as set out under the proposal, then they would expect all entry parties who are paying the SO commodity charge to be participants in any redistribution of over (and under) recoveries.

Invoicing

One respondent commented on Transco's proposed invoicing timetable. The respondent considered that Transco's proposed scheduling of invoices seemed to be the most efficient and pragmatic approach to avoid any unnecessary recalculations and rebates.

Transco's views

Transco did not support this proposal. Transco considered that while implementation of this proposal would be consistent with an early implementation of PC 73, this would also generate administrative and system costs for both shippers and Transco. It considered that given the views expressed by respondents, the merits and disadvantages of implementation of this proposal were finely balanced, and therefore at this point in time Transco did not recommend implementation.

Transco considered that should Ofgem choose not to implement this proposal it may be appropriate to reconsider the issue of the basis of the SO commodity charge in the context of its application to both entry and storage flows in a further pricing consultation process.

Cost reflective charging

Transco considered that whilst the charges may lead to a more equitable redistribution of SO costs between entry and exit, Transco was less clear as to whether the new charges would be cost reflective.

Transco did not believe that the proposal, if implemented, would lead to any more variations in the under or over recovery of revenues as a result of the use of forecast gas flows in setting the charge.

Implications for offshore producers

Transco disputed respondents' claims that this proposal, if implemented, could be detrimental to security of supply. Transco stated that new developments seeking to extract gas for sale at the NBP would recognise the incremental cost, which is simply a splitting of the commodity charge which would otherwise be levied on exit flows only. Transco therefore believed that the application of the NTS SO commodity charge to entry flows would not distort the price of gas to end customers nor should it affect the profitability of producers.

NBP gas prices

Transco agreed with those respondents who considered that the possible introduction of the NTS SO entry commodity charge might be expected to increase the cost of delivering gas to the NBP. However it commented that in an efficient market, an increase in costs should be accompanied by a reduction in the cost for delivering gas from the NBP to the customer, such that the total cost of bringing gas onto the system and delivering it to the customer may not be significantly different from the present level of such cost.

Invoicing

Transco noted that given the complexity associated with the invoice processing, Transco would not consider it appropriate to contemplate implementation prior to the expected implementation of the first phase of the Gemini project (scheduled to begin on 1 November 2003). Transco also noted that there may be cost implications for shippers as they may have to modify their IT systems to process new invoices.

Implementation date

Transco has further suggested that the total system implementation costs are around £ 200 000 and has recommended a revised implementation date of 1 November 2003 in line with the introduction of the Gemini system.

Ofgem's views

As we set out in our decision letter on PC73, Ofgem continues to believe that applying the SO commodity charge to both entry flows and exit flows would allow for better cost targeting because the costs Transco incurs as SO in operating the NTS can be caused by the patterns of gas entering or exiting the system. As such, Ofgem considers that this proposal would increase cost reflectivity in Transco's charging and therefore promote competition between shippers and suppliers. Ofgem would also note that by implementing Transco's charging methodology the proposal also facilitates the efficient discharge of Transco's obligations under its GT licence.

Implications for offshore producers

Ofgem is not convinced by arguments raised by upstream market participants that this proposal would discourage offshore investment on the UK continental shelf. To the extent that the SO commodity charge is designed to recover transportation charges in a more cost reflective and non discriminatory manner, the charge should better facilitate competition between relevant shippers and suppliers.

Impact on wholesale markets

Ofgem notes that several wholesale market participants have expressed significant concerns regarding the impacts that this proposal may have on wholesale liquidity and the timing of its implementation. In its decision letter on PC73, Ofgem recognised that the introduction of this change to Transco's charges has implications for shippers with existing contracts and therefore agreed that the implementation of the methodology should be delayed to October 2003.

However, given the concerns raised by several wholesale market participants concerning impacts on market liquidity, Ofgem considers that a delay in the introduction of an SO entry commodity charging component would minimise the potential of these impacts and would allow the wholesale market additional time to factor in an SO entry commodity charge into NBP prices.

Whilst market participants have already had some notice of the implementation of this proposal, Ofgem considers that given the nature of the responses received to this modification proposal it is appropriate that implementation be re-scheduled for October 2004. Ofgem also notes that some upstream participants have raised concerns that pre-existing long term supply contracts extend beyond the existing implementation date. Ofgem considers that a further delay in implementation would allow additional time for renegotiation of these contracts.

Applicability to storage sites

PC 70 was implemented with the intention of applying the SO commodity charge to all system users. Ofgem continues to believe that, in principle, storage flows should not be excluded from the application of the SO commodity charge. Ofgem continues to believe that consideration should be given to the applicability of the charge to storage sites and we would welcome further proposals to amend the network code to apply the SO commodity charge to storage flows in a cost reflective manner.

Optional Commodity charge

Whilst not the subject of this proposal, Ofgem would also reiterate the views expressed in its decision on modification proposal 0600 that it is important that Transco review the Optional Commodity charge and consider the extent to which the present charge is cost reflective.

Interaction with electricity market

Ofgem agrees with the views expressed by several respondents that this proposal better aligns Transco's and NGC's charging methodologies.

Implementation date

In the light of the above arguments, Ofgem considers that this proposal should be implemented from 1 October 2004.

Ofgem's decision

Ofgem has carefully considered the issues raised by respondents and Transco in relation to this modification proposal. We consider that this modification proposal will better facilitate the achievement of Transco's relevant objectives as set out under amended standard condition 9 of its GT licence. In particular the application of more cost reflective charges should better facilitate the securing of effective competition between relevant shippers and suppliers. Further, by giving effect to Transco's charging methodology the proposal should also better facilitate the efficient discharge of Transco's licence obligations.

If you require any further information in relation to this modification please feel free to contact me on the above number or Mark Feather on telephone 0207 901 7437.

Yours sincerely,

Kyran Hanks
Director, Gas Trading Arrangements