Direct Dial: 020-7901 7327

21 September 2001

Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/0464

Dear Colleague,

Modification Proposal 0464 'Supply Point Registration Process for the Optional NTS Commodity Tariff'

Ofgem has considered the issues raised in Modification Proposal 0464 *'Supply Point Registration Process for the Optional NTS Commodity Tariff'*. Ofgem has decided to direct Transco to implement the modification because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

Transco recovers its allowed revenue under its price control formula by charging for gas transportation services, split into capacity, commodity and customer charges. Separate commodity charges are imposed for transportation on the National Transmission System (NTS), the high pressure pipeline system that transports gas in bulk and for Local Distribution Zones (LDZs) which transport gas at lower pressures to smaller, final customers. The standard NTS Commodity Rate is set at a uniform rate, which does not vary by distance, location of sites or actual usage of the NTS. Transco calculates the rate by dividing target NTS commodity revenue for the charging year by its forecast of NTS throughput for the year.

On 9 January 1998, Ofgas (as it then was) decided not to veto Pricing Consultation (PC)9a, *Optional NTS Commodity Tariff* to introduce the NTS Optional (Short haul) Commodity Rate, offering a discounted transportation tariff to large loads situated close to System Entry Points. Subsequently, on 18 May 1998, Ofgas accepted Modification Proposal 214, *NTS Optional Commodity ("Shorthaul") Tariff*, which gave effect to PC9a by amending the Network Code. The (discounted) NTS Optional Commodity Rate is available to shippers at qualifying NTS exit points and is designed to counter any incentive on such shippers to build pipelines to bypass the NTS in circumstances where it may be inefficient to do so. The tariff is derived from Transco's estimated cost of laying a dedicated pipeline from a terminal to a particular exit point, based on a range of flow rates and pipeline distance. The 'shorthaul' tariff was therefore intended to ensure that Transco's charges better reflected its costs and did not lead to inefficient investment decisions to build bypass pipelines as a result of Transco's charging structure not accurately reflecting its costs.

Ofgas' approval of the NTS Optional Commodity Rate was conditional on Transco bringing forward tariffs that better reflected costs for all customers. In its decision not to veto PC9a, Ofgas stated, 'Ofgas expects Transco to propose extending the principle of more cost-reflective commodity charges to all users of the system in time for October 1998.'

In response, in May 1998, Transco proposed a distance-related NTS Commodity Charge in PC32, *NTS Distance Related Commodity Charge*. The proposed charge was based either on estimates of the average distance to each exit zone from feasible entry points or on a similar approach with the exit zones aggregated into three nodes. However, following general opposition to the proposals, Transco withdrew the proposal.

The split of NTS transportation charges between (entry and exit) capacity and commodity charges in recovering allowed revenue under the price control was initially set at 50:50 i.e. capacity charges were set at a level to recover half of the allowed revenue in each charging year. The share of allowed revenue recovered from capacity charges has, however, progressively increased and is now (initially) set at 65:35, following Ofgas' decision not to veto PC12, *NTS Capacity/Commodity Split*, which was raised in October 1997. The proposal to increase the share of revenue derived from capacity charges was based on Transco analysis which indicated that the majority of NTS costs are related to providing peak capacity and only a small proportion are related to throughput. Accordingly, a move to a 65:35 split was said to be a move towards better cost reflectivity in Transco's charging.

However, the introduction in September 1999 of monthly auctions for the allocation of NTS entry capacity signalled a move towards a more value-based determination of the capacity commodity split. Entry capacity is auctioned at each system entry point. If the value of capacity revealed through prices paid in the auctions is higher than the old, administered capacity charges, Transco would, in the first instance, reduce NTS commodity charges to ensure that overall, it recovered its allowed revenue.

In July 2000, Ofgem decided not to veto the entry capacity auction revenue rebalancing mechanism established under PC60, *Rebalancing Revenue raised by Monthly System Entry Capacity (MSEC) and other NTS Auctions*. Under this mechanism the NTS commodity charge is adjusted for over or under recoveries of entry capacity revenue in excess of 10%. If as a result of the auctions, the value of capacity is high relative to the old administered charges, the commodity charge is reduced, subject to a minimum level, such that Transco continues to recover its allowed revenue. The minimum level below which the commodity charge cannot fall was set at a level to reflect Transco's short run avoidable costs associated with transporting gas across the NTS. This minimum level was set to ensure that in adjusting the commodity charge following an over-recovery from the auctions Transco did not breach its licence obligation to set charges that reflect its costs.

The auction revenue re-distribution mechanism has subsequently been amended following Ofgem's decisions on 24 August 2001 not to veto PC65, *Alternative Method of Funding Entry Capacity Constraint Management* or PC66, *Transportation Charge Adjustments Following Entry Capacity Auctions*.

Under PC 65 if auction revenues exceed target revenues by more than 10% the excess is divided into equal monthly amounts and used to fund shippers' share of any entry capacity buy-back costs. Under this proposal any over-recovery not rebated according to this methodology will be dealt with through adjustments to the general level of transportation charges as under the existing methodology. Under PC 66 any under-recovery from the auctions would be made up through increases to general transportation charges rather than being focussed solely on the NTS commodity charge.

The effect of these decisions is to potentially reduce the extent to which the standard NTS Commodity Charge would be adjusted following an over or under-recovery of revenue from monthly entry capacity auctions. In particular, in the event of an over-recovery, the commodity charge would only be reduced if shippers' share of buy-back costs were less than the size of the over-recovery.

While the intention of the NTS Optional Commodity Rate was to offer a discounted charge for 'short hauls', the introduction of the revenue re-distribution mechanism created the situation in which the NTS Optional Commodity Rate could be higher than the standard NTS Commodity Rate. This could occur as a result of an over-recovery against allowed revenues in the entry capacity auctions, which would reduce the standard NTS Commodity Charges. Conversely, in the event of an under-recovery, the differential between the standard NTS Commodity Rate and the NTS Optional Commodity Rate could widen.

There is no mechanism for the NTS Optional Commodity Rate to be adjusted in the event of an over or under-recovery. Currently, where an over-recovery occurs, shippers on the NTS Optional Commodity Rate may elect to revert to the standard tariff by re-registering their site. However, some shippers have complained that the existing mechanism to effect such a transfer is unduly onerous when applied solely for the purpose of changing tariff and is unduly restrictive in that re-registration may only take effect on the first day of any month.

As a result, Scottish and Southern Energy raised Modification Proposal 455, *Application of the Optional NTS Commodity Rate*. This proposal provided that the definition of the Applicable Commodity Rate for exit points registered for the Optional NTS Commodity Rate would be the lower of the standard NTS Commodity Rate and the NTS Optional Commodity Rate. This would obviate the need for shippers to re-register sites eligible for the NTS Optional Commodity Rate following a revision to the standard NTS Commodity Rate.

Subsequently, Transco raised the proposal that forms the subject of this decision.

The modification proposal

This proposal seeks to streamline the site registration process set out in the Network Code where a shipper elects to switch between the standard NTS Commodity Rate and the NTS Optional Commodity Rate. This would typically follow a change to the standard NTS Commodity Rate made as a result of revenue re-distribution from the NTS capacity auctions. The process would not be available for shippers electing to change any other site details or for those shippers that have not previously been billed on the optional tariff, because further site details would have to be registered with Transco in such circumstances.

The proposed amendment to the existing registration requirements would involve a reduction in the list of information requirements that are required as part of the re-registration process and a shortening of the minimum timescales set out in the

Network Code. The current restriction on shippers only being permitted to change the form of NTS Commodity Rate on the first day of any month would also be lifted and for consistency this would also be carried over to the optional Local Distribution Zone (LDZ) tariff process.
As part of this proposal, Transco also proposes to amend an incorrect reference within Section B 1.8.5 of the Network Code, which provides for the NTS Optional Commodity Rate.

Respondents' views

All of the six respondents to this Modification proposal supported it.

However, one respondent would also have considered a pricing consultation, by which the Optional Commodity Rate would be reduced by the same percentage as the standard commodity rate.

Another respondent, while supporting the proposal, would have preferred an automated approach, as proposed in Modification Proposal 455, whereby the lowest prevailing NTS commodity charge was always applied. In relation to this approach, another respondent accepted that Modification Proposal 464 achieved Transco's objective of shippers being in control of a process which applies a revised transportation charge, without the 'onerous re-registration process in its entirety'.

One respondent supported the proposed implementation date of 1 August 2001, on the basis that both shippers and customers would benefit from its implementation before the completion of the next series of entry capacity auctions.

Ofgem's view

Following the introduction of entry capacity auctions and a more market-based mechanism for determining the split between entry capacity and NTS commodity charges, Ofgem believes that Transco should, as a matter of urgency, consider whether its existing charging methodology that gives rise to a Standard and an Optional Commodity rate remains appropriate in the light of its obligations under its Gas Transporter's licence and the Gas Act. Ofgem would also expect Transco, as part of this review, to seek to extend the principle of more cost-reflective commodity charges to all users of the system as Ofgas indicated it should in 1998.

Notwithstanding these concerns, Ofgem must consider this modification proposal on the basis of whether it, compared with the existing arrangements, better facilitates the relevant objectives set out in Standard Condition 7 of Transco's licence.

Ofgem agrees with respondents that the current requirement to re-register a site in order to take advantage of the standard NTS Commodity Rate, is unduly burdensome. In addition, we accept that the current requirement to register only on the first day of any month may be unduly restrictive.

The effects of these requirements can be to lead to certain shippers paying higher commodity charges than would be the case if the restrictions were removed and higher commodity charges than other shippers on the standard rate. These different charges do not appear to reflect differences in the costs incurred by Transco in providing transportation services. As the different charges are set by Transco (not

the result of shippers' bids through an auction process) and are the result of Transco's own administrative procedures, Ofgem is concerned that these restrictions may be prejudicing the economic and efficient operation of the pipeline system and the facilitation of competition between shippers.
Accordingly, we believe that the simplified process put forward in this Modification Proposal would better facilitate the relevant objectives of the efficient and economic operation of Transco's pipeline system and facilitation of competition between shippers.

Ofgem's decision

Ofgem has therefore decided to direct Transco to implement the modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Gas Transporter's licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Steve Smith
Director, Trading Arrangements