Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification Proposal 0600 'Amendment to Optional National Transmission System (NTS) Commodity Rate requirements to input gas at the local entry point'

Scottish and Southern Energy plc (SSE) raised modification proposal 0600, *Amendment to Optional National Transmission System (NTS) Commodity Rate requirements to input gas at the local entry point*, on 15 November 2002.

Ofgem has considered the issues raised in this modification proposal and the responses received and has decided to direct Transco not to implement this proposal because we do not believe that it will better facilitate the relevant objectives of Transco's network code.

We have set out below our reasons for making this decision.

Background

The 'shorthaul' tariff

The optional NTS commodity tariff was introduced in 1998, following Ofgas' (as it then was) decision not to veto Transco's pricing consultation (PC) 9a, *Optional NTS Commodity Tariff*, and its acceptance of network code modification 0214, *NTS Optional Commodity ("Shorthaul") Tariff*. The Optional NTS Commodity Tariff otherwise known as the 'shorthaul' tariff offered a discount to Transco's then standard NTS commodity rate.

At that time, Transco recovered its allowed revenue under its price control formula by charging for gas transportation charges, split into capacity, commodity and customer charges. There were separate commodity charges for transportation on the NTS and for Local Distribution Zones (LDZs). The standard NTS commodity charge was set at a uniform rate, which did not vary by distance, location of site or actual usage of the NTS. Transco derived the rate by dividing target NTS commodity revenue for the charging year by its forecast of NTS throughput for the year.

The shorthaul tariff offered a discounted NTS commodity charge for loads located close to NTS system entry points. The discount was designed to counter any incentive on such loads to bypass the NTS where it may be inefficient to do so. The tariff is derived from Transco's estimated cost of laying a dedicated pipeline from an entry 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' decision not to veto PC9a was conditional on Transco bringing forward tariffs that better reflected costs for all customers. However, while Transco proposed a distance related NTS commodity charge in PC32, it withdrew the proposal in response to general opposition.

In our decision letter on modification 0214, Ofgas specifically considered the issue that is the subject of this proposal, ie whether shippers should be able to receive the shorthaul tariff on all offtakes from an eligible exit point, regardless of whether the shipper has input gas at the local terminal. Ofgas accepted that it was inappropriate for a shipper to benefit from the shorthaul tariff if it did not input gas locally ('the local terminal rule'). As a consequence, a shipper offtaking gas from a qualifying exit point is eligible for the shorthaul tariff only to the extent that its inputs of gas at the local terminal are equal to or greater than its offtakes at the relevant exit point.

Transco's 2002-7 price control arrangements

Transco's price control for the period 1 April 2002 to 31 March 2007 split the regulation of Transco's role as NTS transmission asset owner (TO), where it builds and maintains the network, from its role as NTS system operator (SO), where it determines the need for additional NTS capacity and operates the system day to day. The TO control is further split between the NTS and the LDZs.

Consistent with this new framework, Transco recovers TO allowed revenue through entry and exit capacity charges. In addition, as a result of the implementation of PC70, *NTS System Operation Transportation Charges*, Transco replaced the NTS Commodity Tariff with an NTS SO commodity charge that is intended to recover the costs of Transco's system operation. The SO commodity charge is based upon Transco's target SO revenue and is currently charged on the basis of measured gas flows at NTS exit points. From 1 October 2003 this charge is to be based upon both entry and exit flows as a result of the implementation of PC73, *Structure of the NTS SO Commodity Charge.*[1]

In PC70, Transco considered whether it was appropriate to continue the shorthaul tariff. While recognising that the continuation of the shorthaul tariff in its current form may not be an ideal method of dealing with the issue, it believed that it was a pragmatic method of helping to avoid uneconomic bypass. Whilst Ofgem did not veto PC70, we stated that Transco should 'review as a matter of urgency the extent to which the charging methodology gives rise to an Optional Commodity rate that reflects the costs incurred by the licensee in its transportation business within the terms of its Gas Transporter's licence (Standard Condition 4A)'.

The proposal

Modification proposal 0600 provides for an amendment to the network code to widen the criteria for eligibility to the shorthaul tariff. The proposal provides that a shipper would be eligible for the shorthaul rate on all gas offtaken at a qualifying

[1] However, it is noted that the implementation of the changes to Transco's pricing methodology established by PC73 is subject to the outcome of modification proposal 626, '*Structure of the NTS SO Commodity Charge*', which is intended to give effect to the new methodology.

exit point, so long as the amount of aggregate (ie, all shippers') inputs at the local terminal is equal to or greater than the gas offtaken at the relevant exit point. Where there is more than one relevant exit point, eligibility for the shorthaul rate would be pro-rated to exit nominations.

Respondents' views

There were ten responses to this modification proposal. The majority of respondents did not support the proposed amendment.

Cost reflective charging

In raising this proposal, the proposer considered that the local terminal rule was unduly restrictive and acted to incentivise shorthaul loads to bypass the NTS, by forcing shippers to secure entry capacity at high prices. The proposer argued that, if a shipper purchased gas at the NBP, the actual physical flow of gas to the site would still be from the local terminal. It therefore argued that it would not be cost reflective to charge such flows at the standard NTS SO commodity rate.

A number of respondents argued that the proposal would undermine the purpose behind the shorthaul rate, which incentivised shippers to input gas at the local terminal to where they were consuming gas and would provide a cross-subsidy between shippers based on the location of their offtakes. In this context, it was argued that if the local terminal rule was removed a shipper could benefit from the shorthaul tariff even though the gas used could be travelling from a distant terminal and in fact using more of the NTS.

System benefits

Some respondents who supported the proposal considered that by extending applicability for the shorthaul tariff, shippers would be encouraged to consume gas at exit points near to a terminal, which would assist Transco in alleviating potential constraints and benefiting system operation.

One respondent opposed to the proposal suggested that Transco's SO incentive scheme already provides it with incentives to minimise the costs of constraint management. The respondent stated that Transco is able to enter capacity and commodity markets to resolve constraints. For example, Transco could make a local sell offer in order to encourage an end load to consume gas to help alleviate a constraint. Another respondent, opposed to the proposal, argued that if the proposal were approved it should only operate on constrained days.

Increased liquidity and competition

One respondent in support of the proposal considered that where the shorthaul tariff applied, those users would be able to choose gas suppliers based upon price, rather than location, thereby increasing competition and liquidity in the gas and capacity markets. Another respondent stated that it would enable shippers to trade available entry capacity with other shippers and Transco, further developing a liquid secondary market.

Transco's views

Transco did not support this proposal.

Cost reflective charging

Transco considered that removing the local terminal rule could be detrimental to the principle of cost reflective charging, as set out under its licence obligations. It considered that if a shipper did not input gas at the local terminal, then it would be inappropriate to apply a reduced commodity rate because in those circumstances the shipper could not have contemplated a direct bypass of the system.

System benefits

Transco recognised that this modification proposal would act as an incentive for loads located close to entry terminals to consume gas from the NTS. However, Transco considered that this proposal was unlikely to reduce the likelihood of constraints on the system. Transco argued that the likelihood of constraints depends on the exact cause and location of each constraint, which may not necessarily be affected by significant offtakes at the relevant exit point.

Increased liquidity and competition

Transco considered that the proposal could increase competition between shippers at relevant entry points. It considered that greater flexibility in delivering gas at entry points might impact the extent of entry capacity trading, but considered that the effect on liquidity is not clear.

Ofgem's views

General comments on cost reflective charging and the Optional commodity charge

The NTS Optional Commodity Charge ('short-haul tariff') was introduced to reflect the fact that the standard NTS commodity charge, which did not vary by distance, was not considered to be cost reflective when applied to loads located close to system entry points and was therefore necessary to prevent the possibility of uneconomic bypass of Transco's system.

As noted above, Transco has now replaced the standard NTS commodity charge with an SO commodity charge through PC70. 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).

Ofgem would note in this context that the SO commodity charge is primarily intended to recover the costs of Transco's system operation. Whilst some of these costs may vary according to the distance by which gas is transported, Ofgem is not satisfied that Transco has performed an analysis to demonstrate the extent to which the system operation costs associated with transporting gas to loads close to entry terminals are significantly lower than the costs of transporting gas to other points. In this context, it may be the case that shippers who benefit from the short-haul tariff are benefiting from cross-subsidies with respect to the allocation of system operation costs.

Further, it would seem inappropriate for any reduction in pipeline investment or capacity costs associated with supply points being located close to entry points on the Transco's NTS to be reflected in an SO charge as opposed to a TO charge. Instead, following the introduction of the TO and SO split created as part of Transco's price control for 1 April 2002 to 31 March 2007, it would seem more appropriate that any savings in pipeline investment costs should be addressed through other charges (eg exit charges).

For the reasons outlined above, Ofgem would therefore reiterate that Transco should review the Optional Commodity tariff methodology. This review should consider whether the present charge is cost reflective. It should also consider the appropriateness of discounted charges such as the Optional Commodity Charge within the context of an entry/exit pricing regime. Whilst it appears appropriate to counter system bypass incentives on loads located close to entry points, this could be achieved through the present entry and exit pricing regime and, in particular, through exit charges. In this respect, Ofgem considers that any review of the methodology should assess whether or not loads located close to entry points benefit from sufficient savings in exit capacity charges that reflect their position on the network.

In view of this background, Ofgem is not convinced that this proposal, which effectively seeks to widen the scope of the short-haul tariff, will ensure that large loads and offtakes located near to entry terminals will receive cost-reflective transportation charges in circumstances where the charge itself may not be cost reflective.

Further, even if it is assumed that the short-haul tariff methodology applied by Transco does reflect the costs of supplying gas to the load from the local terminal, Ofgem is concerned that this proposal would depart from the principle of cost reflectivity by allowing shippers to enter gas at terminals other than the relevant local terminal on which the charge is based. As some respondents have noted this could lead to cross-subsidies in favour of shippers supplying gas to the relevant supply points that benefit from the reduction in charges.

Therefore we continue to believe that it is appropriate to restrict the application of the shorthaul tariff by applying the local terminal rule in the context of Transco's current charging structure.

Impact on the entry capacity regime

Ofgem notes that the proposer has stated that the proposal would provide financial incentives on loads to consume gas from the NTS thereby reducing the probability of entry capacity constraints.

Ofgem is not satisfied that the proposal would reduce the probability of entry capacity constraints and notes that Transco already has system balancing tools within the entry capacity regime to manage constraints effectively. As such, to the extent that a particular site provides constraint relieving benefits it is open to Transco to enter into a system management contract with that particular site.

In this context, Ofgem considers that Transco's SO incentive framework should provide it with financial incentives to purchase services of this nature where it is efficient to do so, thereby rewarding the providers of such services. In this way, any particular benefits provided by individual offtakes would be specifically recognised through the entry capacity regime.

Related to this, Ofgem is not satisfied that the additional benefits provided to short-haul tariff sites would necessarily reflect the value, if any, that they provide in assisting Transco in managing entry capacity constraints. For example, offtakes located close to entry points may provide system balancing benefits on some days but not necessarily all days, contrary to the rationale underlying this proposal.

Ofgem is not therefore satisfied that the proposal would produce more cost reflective charging. Instead it may risk providing benefits to certain shippers that are not justified and therefore would not better facilitate the securing of effective competition between shippers and suppliers.

The proposer also states that the proposal would discourage loads from bypassing Transco's system where there are risks of high entry capacity costs.

However, Ofgem considers that the mere presence of high entry capacity charges at a relevant local terminal does not of itself suggest that users located close to that terminal should obtain an effective reduction in transportation charges in circumstances where the relevant shipper is effectively utilising entry capacity.

Interaction with the electricity market

Under electricity trading and transmission arrangements for England and Wales, NGC charges system users transmission network use of system charges (TNUoS) to recover the cost of investment in and maintenance of NGC's transmission system (its TO allowed revenue). TNUoS charges vary on the basis of where generation and demand are located on NGC's system, resulting in a number of generation and demand zone tariffs. NGC also levies a balancing services use of system (BSUoS) charge, to recover NGC's costs and incentive payments as system operator. The BSUoS is a standard rate and is recovered on the basis of metered volumes.

There are no equivalent short-haul charges levied by NGC with respect to either its TO or SO price controls.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to direct Transco not to implement this modification proposal, because we do not consider that it would better facilitate the relevant objectives of securing effective competition between relevant shippers and between relevant suppliers or the efficient and economic operation by Transco of its pipe-line system, as contained in Amended Standard Condition 9 of Transco's GT licence.

In particular, Ofgem is not satisfied that the proposal would result in more cost reflective charges and is therefore not satisfied that the proposal would better facilitate the securing of effective competition between shippers and suppliers. Further, Ofgem is not satisfied that encouraging loads in close proximity to entry terminals to consume gas irrespective of whether constraints were present would necessarily better facilitate efficient operation.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on telephone number 0207 901 7431.

Yours sincerely,

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