



Shippers, Transco and Other
Interested Parties

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Dear Colleague,

Modification Proposal 0576: 'Provision of information relating to the S0 commodity charge'

Ofgem has considered the issues raised in modification proposal 0576, '*Provision of information relating to the S0 commodity charge*', and has decided to direct Transco to implement the modification because we consider 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 reasons for making our decision.

Background to the proposal

The modifications made to Transco's Gas Transporter (GT) licence on 27 September 2002¹ established Transco's Transmission Asset Owner (TO) price control for 2002-2007 and put in place a series of System Operator (SO) incentives for the National Transmission System (NTS). The modifications took effect from 1 April 2002 and separate the regulation of Transco's role as TO, whereby it builds and maintains the NTS, from its role as SO whereby Transco determines the need for additional capacity and operates the NTS on a day-to-day basis.

Transco collects NTS SO allowed revenue through an SO commodity charge and collects NTS TO allowed revenue through entry and exit capacity charges.

¹ *Transco Price Control and NTS SO incentives 2002-2007, Licence Modifications*, Ofgem, September 2002.

The NTS SO commodity charge

On 18 January 2002, Ofgem decided not to veto Transco's Pricing Consultation (PC) 70, '*NTS System Operation Transportation Charges*', which introduced the SO commodity charge. The SO commodity charge recovers elements of NTS SO allowed revenue, including system balancing costs, NTS SO internal costs and the revenues or payments arising from the NTS SO incentive schemes. The SO commodity charge became effective from 1 April 2002 and applies to gas offtaken at exit points (other than offtakes to storage sites²) from the NTS. Following Ofgem's decision not to veto PC 73, '*Structure of the NTS SO commodity charge*', in July 2002, the SO commodity charge will apply to both entry and exit flows on a 50:50 basis from 1 October 2003.

Under Transco's GT licence,³ Transco must use its best endeavours in setting its charges to ensure that, in respect of any formula year, the revenue it derives from its SO activities does not exceed its maximum SO allowed revenue.

The level of the SO commodity charge was increased from 0.0089 p/kWh (0.261p/therm) to 0.0150 p/kWh (0.440 p/therm) on 1 July 2002. Subsequently, on 1 November 2002, Transco raised Pricing Discussion (PD) paper 16, '*Balance of Transportation Charges and Indicative Charges from April 2003*'. In this paper, Transco gave notice of an increase in the level of the standard SO commodity charge, to 0.0177p/kWh (0.519 p/therm), to take effect from 1 January 2003. Transco stated that the increase is necessary to address a likely substantial under-recovery of SO revenue in the current formula year. Transco also stated that, while not removing all of this forecast under-recovery in the present formula year the charge should be sustainable through to 2004 on the basis of its current revenue projections.

Certainty in transportation charges

On 17 October 2002, Ofgem released its decision on Transco's Pricing Consultation Paper PC 75, '*NTS TO Commodity charge*'. This consultation proposed the introduction of a TO commodity charge to allow for the redistribution of over or under recoveries of TO revenues.

² A consequence of PC 70 is that the SO commodity charge should apply to flows off the NTS into storage sites, but in order to effect this, a change to the network code is required. There are currently three alternative network code modification proposals awaiting Ofgem's decision, namely, modification proposal 0532, '*Application of SO Commodity Charges to all NTS Loads*', modification proposal 0545, '*Application of SO Commodity Charges to Storage Facilities*', and modification proposal 0547, '*Reconciled SO Commodity Charges at Storage Facilities*'.

³ Special Condition 28B, Part 2 12 (1)

Ofgem vetoed this proposal on the basis that the proposal lacked certainty as to how the proposed charge would be set and adjusted. In issuing its decision letter, Ofgem commented that Transco should give consideration to developing a sufficiently specified and detailed methodology to determine the circumstances in which the charge may vary and to assist shippers' understanding of the method by which Transco sets its revenue forecasts.

Ofgem also suggested that Transco could give consideration to proposals that would provide for transportation charges to be revised once a year only, with sufficient notice being given to shippers of this change.

The proposal

AEP Energy Services Ltd (AEP) raised modification proposal 0576 on 9 August 2002. AEP proposed that, in order to enable shippers and customers to manage the risks associated with volatility in the level of the SO commodity charge by forecasting adjustments to the level of charges, Transco would be obliged to publish the following information on its information exchange website:

At the start of each charging year:

- Transco's forecast of annual system throughput and monthly system throughput for the next charging year; and
- Transco's forecast of annual and monthly target costs under the relevant SO incentive schemes (system balancing, SO internal costs and exit capacity).

On a quarterly basis:

- Transco's disaggregated outturn costs for each of the relevant SO incentive schemes.

On a weekly basis:

- Actual system throughput; and
- The sum of outturn costs under the relevant SO incentive schemes.

AEP proposed an implementation date of 1 October 2002.

Respondents' views

Seven responses to this modification proposal were received. The majority of respondents supported the proposal. They considered that greater transparency in the information used by Transco in setting the SO commodity charge would assist shippers in forecasting any potential adjustments to charges. Respondents indicated that this would facilitate competition in shipping and supply. In this respect, respondents commented that shippers would be able to use this information to reduce the risk premia charged by suppliers, thereby resulting in lower prices for customers.

A number of respondents suggested that the proposal would allow for a greater alignment between gas and electricity in the amount of information released on the setting of commodity charges. It was noted in this respect that NGC is required to report on the operation of its various incentives schemes and its performance under those schemes.

Several respondents considered that Transco would generate outturn results and costs internally in order to monitor its incentive performance and therefore should be able to provide the information. The respondents suggested that to the extent that this was not the case, Transco should make every effort to provide the information requested.

One respondent stated that Transco has a best endeavours obligation in setting charges each year to ensure that its revenue in respect of its NTS SO activities does not exceed the maximum NTS system operation revenue. In this respect it indicated that Transco has an obligation, based on its best available forecasts at that time, to seek to recover its allowed revenue that year and to review these charges throughout the year, resetting them where an under or over recovery is likely as actual data replaces forecast data. It expressed a concern that Transco would not adjust its charges towards the end of a charging year to avoid an under or over recovery simply in order to achieve stability. It said that, although stability is desirable, a failure to adjust charges could lead to distortions in competition and appeared inconsistent with Transco's obligations to ensure that charges reflect costs. Another respondent commented on this issue and indicated that it would prefer to see a charging structure where the factors that impacted upon the SO commodity charges were reviewed on a planned basis following which any necessary adjustment was applied. In this respect the respondent indicated that there would inevitably be a compromise between cost reflectivity and volatility.

One respondent did not support this modification proposal. The respondent suggested that Transco should make more information available, but the level of information to be provided should be discussed through industry workstreams. It indicated that access to the information would not be sufficient to forecast the SO commodity charge and will not help reduce risk to suppliers when setting prices for offers to consumers.

Transco's view

Transco did not support this proposal. It did not believe that the publication of this information would significantly increase shippers' abilities to accurately predict changes in the SO commodity charge. It suggested that the proposal did not accurately

portray Transco's charging obligations, nor its approach to setting the S0 commodity charge.

Transco argued against the implementation of this proposal because it claimed that it does not set charges for a charging year, but seeks to make adjustments to charges only when it is clear that to do otherwise would lead to collected revenues exceeding the maximum allowed revenue under its relevant price control formula. Transco stated that it considers more than one year in the interests of achieving price stability within the obligations set out in its GT licence.

Additionally, Transco considered that the majority of information requested by AEP was unavailable. In particular, it stated that it could not provide a monthly split of targets under the relevant S0 incentive schemes, because they had been set by Ofgem on the basis of a formula year. Transco stated that it did not produce outturn costs on a weekly or quarterly basis and hence these costs were unavailable. For example, its S0 internal costs included recharges from a number of Transco departments and these are not available on a weekly basis. It also stated that exit capacity costs were a significant part of the requested information and were calculated on the basis of a snapshot at one point in time, rather than accruing on a daily basis.

Transco also noted that the throughput information requested in the proposal is already published on a daily basis.

Transco considered that the implementation of this proposal would lead to substantial requirements for system and business process changes in order to accommodate weekly, quarterly and annual data. Transco considered that the changes required to facilitate the provision of this information would be in the order of £100k.

Transco did however accept that increased certainty regarding future charge levels is of potential benefit. However it did not accept that providing the information sought in the proposal would increase certainty. Transco also noted that it intends to make only occasional changes to the S0 commodity charge and these changes would follow the required notice periods. Transco also indicated that it intends to consult on options for setting transportation charges in the future that would provide industry participants with an opportunity to contribute to the consideration of the potential benefits of increased certainty regarding the future level of transportation charges.

Ofgem's view

Certainty in transportation charges

Ofgem is conscious of concerns expressed by the industry about potential volatility in transportation charges and, as suggested in our decision letter on PC 75, we continue to believe that Transco should give consideration to revising transportation charges once a year only, with sufficient notice being given to shippers of this change. In this respect Ofgem considers that restricting changes to transportation charges on an annual basis would facilitate competition in the wholesale gas market. In this regard, Ofgem notes Transco's recent PD16 paper which indicates that the increase in the S0 commodity charge to take effect from 1 January 2003 represents an increase to a level that should be sustainable through to 2004.

Whilst the proposed change in the S0 commodity charge outlined in PD16 reflects an intent on the part of Transco to minimise the potential for changes to the S0 commodity charge during 2003, the possibility of such changes cannot be completely ruled out depending on the effectiveness of Transco's forecasting.

In view of this, Ofgem considers that the provision of the information specified in this proposal will allow shippers and customers to better manage their risks in relation to possible further adjustments to the S0 commodity charge, by being better able to monitor Transco's performance under its S0 incentive schemes. In particular, based upon the representations received through the consultation process, Ofgem considers that the provision of the information specified in this proposal should assist shippers and suppliers in setting prices and reducing uncertainty. In this respect, we consider that the proposal better facilitates the securing of effective competition between relevant shippers and between relevant suppliers, by allowing shippers to better forecast future adjustments to the S0 commodity charge.

Whilst not forming part of this proposal, we also wish to reiterate the views we expressed in our decision on PC 75 that Transco should clearly specify a methodology to assist shippers in determining the circumstances in which transportation charges, such as the S0 commodity charge, may vary. A clearly specified methodology of this nature would also assist shippers and suppliers in managing their risks and would facilitate competition.

Ofgem also continues to believe that shippers, the wider industry and customers have a valid role to play in monitoring Transco's performance under its S0 incentives, because it is customers who ultimately pay for the costs of Transco's S0 activities and charges. Ofgem considers that this proposal will bring increased transparency to the components of Transco's S0 commodity charge and this

information will therefore better enable the gas industry to monitor Transco's performance.

Ofgem notes Transco's proposal to consult on options for setting transportation charges in the future. Whilst Ofgem welcomes this initiative, likelihood of a future consultation on these issues cannot preclude the implementation of a proposal that better facilitates the relevant objectives of Transco's network code when assessed against the background of the licence and the network code as they presently exist.

Transco's ability to provide the information

Ofgem considers that Transco should be able to provide the information specified in this proposal. In particular, while Ofgem has specified the relevant SO incentive schemes on the basis of a formula year, the proposal provides for Transco to publish its *forecast* of annual and monthly target costs. In particular, Transco should be able to break down an annual target level of costs into monthly amounts in an appropriate way to reflect the likely profile of these costs.

In relation to Transco's actual costs under the relevant SO incentive schemes, Ofgem considers that Transco should be monitoring its own performance under the incentive schemes and should therefore be able to provide the data that forms the subject of this proposal.

Electricity interactions

Ofgem also considers that this proposal will bring about greater alignment between the information provided in the gas and electricity sectors in relation to SO charges, given NGC's practice of publishing information on its balancing services use of system charge on a daily basis on its industry information website.

Ofgem's decision

Ofgem considers that this proposal will better facilitate the relevant objectives of Transco's network code. In particular, we consider that the provision of information in relation to the components of the SO commodity charge will help to secure effective competition between relevant shippers and relevant suppliers by enabling shippers and suppliers to better manage their risks in setting their prices.

For the reasons outlined above, Ofgem has decided to direct Transco to implement this modification proposal.

As the proposed implementation date of 1 October 2002 has passed, this proposal should be implemented from 1 December 2002.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on 020 7901 7431.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Feather', written in a cursive style.

Mark Feather
Head of New Gas Trading Arrangements