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TRANSCO CONSULTATION REPORT ON PC9A

OPTIONAL NTS COMMODITY TARIFF

1. Transco's Initial Proposal

A consultation paper on proposals for an optional NTS commodity tariff, PC9A, was circulated to shippers and the industry on 19 November 1997.

In the consultation paper it was proposed that an optional NTS commodity tariff should be introduced. Where so elected by the shipper, the optional commodity tariff would be levied in place of the standard commodity tariff to the extent that the shipper brought gas into the system at the local terminal for offtake at the supply point. The standard commodity tariff would continue to apply to the extent that gas was sourced from other terminals. The tariff would be available to all daily metered supply points. However in practice it would only be attractive to large supply points/offtakes situated close to terminals.

The rationale for the optional tariff is to begin to address pricing policies that appear to give perverse economic incentives to system users and may appear to be unduly discriminatory between certain categories of users. The proposed tariff is based on the cost of building and maintaining a dedicated pipeline from the terminal to the supply point (i.e. the standalone cost of a transportation service). The price is a function of distance from terminal to supply point, load factor and load size.

In recognition of the fact that the supply point would continue to be connected to the integrated network, it was proposed that standard capacity charges would continue to be payable for a firm service.

2. Responses to the Consultation

Transco received 16 responses to the consultation paper; comprising ten shippers/suppliers, one terminal operator, three industry groups, one end user and one consultant.

All of the respondents expressed support for the proposals, ranging from unequivocal support to those who included some reservations and requests for further information.

Shippers/suppliers	Mobil Gas Marketing	(Mo)
	BG Trading	(BGT)
	Quadrant	(Q)
	Scottish Hydro	(SH)
	National Power	(NP)
	AGAS	(AG)
	Amerada Hess	(AH)
	Amoco	(Am)
	Conoco	(Co)
	Esso	(Es)
Terminal Operators		
	Shell UK Ltd	(SHe)
Industry Representatives		
	Gas Consumers Council	(GCC)
	Teesside Chemicals	(TCI)
	Energy Intensive Users Gp	(EIUG)
Consultants	David Walker	
End User	ICI	

2.1 Level and Structure of Tariff

i) Cost Assumptions

Four respondents (AH,BGT,ICI,SHe) questioned the level of the average load factor used (70%) for the cost analysis. Three believed a more appropriate value to be around 80-90%, and the other (AH) suggested a lower value to reflect smaller DM loads.

One respondent (AH) suggested an assumed project life of 20 years would be more appropriate.

One respondent (ICI) believed the uplift of 15% applied

to pipeline costs to be too high.

One respondent (Am) asked for an opportunity to review the results of the cost analysis work undertaken on general NTS prices.

Transco comments :

In deriving the function, an average load factor was assumed to avoid further complicating the function. We do not believe that this simplification detracts significantly from cost reflectivity.

In the initial proposals, the average load factor of 70% was based on our estimates of the load factors of those loads that we expected to benefit from the optional tariff. More recent analysis of the potential sites indicates that the appropriate load factor is now around 75%.

Taking this into account, along with the comments we have received, we now believe it is appropriate to base the function on a load factor of 75%. This has the effect of decreasing typical charges under the optional tariff by 7% from the initial proposal. We have re-examined our analysis of the number of loads we expect to benefit from the optional commodity tariff in the light of this revised level of charge, and we do not believe that any additional existing or forecast loads, over and above our previous estimate of eight, would be likely to benefit. The proposed reduction in the tariff is too small to have any significant impact on the analysis of pricing effects on other system users outlined in section 4 of the consultation paper.

The modified price function is given in section 3.

In assessing a suitable project life, we considered the range of loads that could benefit from the tariff (Continental Interconnector, power stations, large industrial plants) and use an appropriate project life. We believe that 10 years strikes the right balance, reflecting the expected project lives.

The uplift of 15% has been included in the costs to take account of project management, bad ground conditions, and pipeline deviations. This is an average figure based on Transco's experience of pipeline construction projects.

ii) Capacity Charges

Three respondents argued that capacity charges should not apply, or should be reduced, for those loads which opted for the NTS Optional Tariff.

Two of these (Co, DW) believed that applying the existing capacity charges seemed excessive, and the other (AG) commented that the capacity charges would be significant (compared to the commodity rate).

The latter also suggested that the entry/exit points for the Continental Interconnector were unique and that the relevant capacity charges should be treated independently (they also proposed that a separate analysis should be undertaken on the costs and services applicable to interconnect pipelines).

Transco comments :

We have maintained the need for shippers who choose this tariff to book exit capacity (for their firm load) and entry capacity in accordance the the Network Code. This reflects the fact that the loads in question will continue to be linked to Transco's integrated transmission system, and may be supplied from any entry point, not only the local terminal. In addition the gas delivered at the local terminal is available for supply to any load on Transco's system, and for trading at the National Balancing Point, not only for supplying the local load. Thus the standard Network Code arrangements are appropriate.

Transco has agreed to review how capacity on the NTS is defined, with the possibility of different levels of firm service becoming available in the future. As proposals are developed, we would anticipate that it would be appropriate to levy differential charges for these different levels of service. It may be that as capacity constraints would almost certainly not apply in the case of local flows, a lower level of firm service may be adequate for local flows, which could then lead to a lower price for this service. However as these principles are at a very early stage, the timing of the availability of alternative capacity services cannot be specified with confidence.

iii) Structure of the Tariff

One respondent (BGT) suggested that the proposed price function was too complex, believing that the formula merely needs to reflect that the commodity rate increases as the SOQ decreases and as the distance, D increases.

Transco comments :

In determining a price function we have attempted to derive a commodity rate which is cost-reflective and a

function of both distance and peak capacity (SOQ). The cost per therm follows a linear relationship with distance, but a non-linear relationship with SOQ which is most easily expressed as a power function.

A considerable amount of data was provided in the paper to enable recipients to satisfy themselves that the functions generated by Transco are a good representation of the relationship between distance, SOQ and costs. We believe that we have struck the appropriate balance between complexity and accuracy, and that a simplified function would not demonstrate sufficient cost reflectivity.

iv) Level of the Tariff

Two respondents (Mo,SHe) expressed the view that the level of the tariff was insufficiently low to prevent bypasses of the NTS.

Transco comments :

We recognise that, depending on economic circumstances, bypasses may still occur. Indeed if we were to set prices on an individual site basis to prevent all bypasses we might be accused of predatory pricing. The intention of this tariff is to offer an alternative commodity charge which is more cost-reflective than the current NTS charge and can be assessed alongside other options available to users.

The level of the tariff also reflects the benefits of being connected to the NTS, which users will wish to consider when deciding which option to pursue. Users may of course choose to accept an interruptible supply and hence avoid any liability for exit capacity charges. In due course, development of new capacity services, as outlined above, may offer the prospect of reduced capacity charges.

2.2 Cost Methodology in Deriving the Tariff

Two respondents (Q, Co) disagreed with the methodology adopted in deriving the formula, which based the tariff on full costs rather than on marginal costs, further commenting that this approach was inconsistent with the NTS charging methodology.

Transco comments :

Transco related the proposed tariff to the full costs of a standalone pipeline to avoid the accusation of

predatory pricing. Our analysis suggests that our marginal costs/savings are much lower and almost zero for short distances close to terminals. However, we believe that to price the service at a rate corresponding to the cost of the least expensive alternative should generate the highest price which is consistent with an efficient outcome and which does not unduly distort the competitive framework. This is, however, an area which we intend to keep under review in the light of market developments.

2.3 Effects on Prices

Two respondents (Am, BGT) requested further analysis to be undertaken, specifically on the effects on prices, taking into account the timing of new loads within the next price control, and the effects across the different market sectors.

One respondent (NP) sought an assurance that the estimates given on the short term increases in general prices would not be exceeded.

One respondent (BGT) suggested that it would be inequitable if the outcome for existing users was a 0.5% increase in prices.

Transco comments :

In our recent consultation paper we indicated that the bulk of the additional load which we expect to take advantage of the optional NTS tariff is not expected to begin flowing until after 1999, and so the full effect on other charges would not apply until after this time. We do not believe that it would be meaningful to attempt to analyse the precise pricing effects of individual future loads starting at different times, as the anticipated commissioning dates are subject to change.

We do not anticipate any differential pricing effect between the different market sectors, as under the present methodology any under-recovery of formula revenue (for example, the £16m shown in Table 1 of PC9A) would be spread across all tiers of the system in proportion to the cost pools.

We believe that the estimate of a 0.5% short term increase in transportation charges is unlikely to be exceeded, as this was calculated based an extreme set of assumptions regarding the loads which might use the tariff. Firstly, it was assumed that all these loads would go ahead in the forecast timescale, and would all choose the optional tariff. In addition the calculation

assumes that the full forecast annual consumption of the loads in question is sourced from the local terminal (i.e. none of the load is subject to the standard NTS commodity tariff). Finally the calculations take no account of the effect of the fixed revenue component of the new price control formula, i.e. there would be no entitlement to additional formula revenue, and hence no effect on prices, if the formula volume in the year in question were to be in the range covered by the fixed revenue condition.

2.4 Competition in Pipelines

One respondent (Am) believed that competition in transportation may still be effected, although they acknowledged that providing the cost basis of the tariff was robust and there was progress in the structure of charges competition in transportation could still develop.

Two respondents (ICI, GCC) believed that the potential impact on competition in transportation where sufficient capacity exists and additional pipelines are not necessary was a spurious argument and they would not wish to see resources wasted on unnecessary duplication of the existing system.

Transco comments :

We welcome the acknowledgement that the proposed tariff should not preclude competition in transportation. However we agree with those respondents who were concerned about unnecessary duplication of pipelines under the present regime, and this concern was one of the drivers for proposing this tariff, in line with our obligation to develop an efficient and economic transportation system.

2.5 Long Term Developments in Pricing

Four respondents (Am, BGT, Q, NP) expressed the view that long term developments in the pricing structure should not be prejudiced by the introduction of this tariff. Two of these (Q,NP) believed that a review of the charging methodology was the preferred solution, and one of these suggested that a cost reflective capacity:commodity split was the answer.

One respondent (BGT) questioned the future of the proposed tariff if those developments in the charging methodology which are anticipated to gradually align general prices with the tariff do not progress.

One respondent (DW) suggested distance related commodity tariffs may also be appropriate for long distances.

Transco comments :

We are co-operating with Ofgas in reviewing the NTS charging methodology, and are also concerned to ensure that the proposed tariff is not inconsistent with the direction in which prices should move. However we have received some preliminary indications that the proposed tariff could be considered to be consistent with longer term developments, and this has encouraged us to re-introduce the proposals at this time.

As regards the situation if longer term developments do not go ahead, as explained in PC9A, once the tariff is established as part of the transportation charging methodology, it would require a further proposal and a consultation process with shippers to amend or withdraw it.

The question of whether distance related commodity tariffs are appropriate for long distance transportation is a issue which could be considered as part of the long term review of NTS prices. However we believe that there is not such an obvious short term sub-optimal economic outcome with the present postalised commodity charge for long distance transportation as we see for short distance transportation.

2.6 Duration of the Service

Two respondents (BGT,SH) requested an assurance that the service would not be removed at a future date.

Transco comments :

Transco has no plans for withdrawing the tariff. In any event, as noted above, the service could not be removed without a further consultation with shippers and subsequent Ofgas approval.

2.7 Further comments raised on features of the proposed service

One respondent (BGT) asked if the service would be available to interruptible contracts.

One respondent (SH) questioned whether it was necessary to link each site to a specific terminal to qualify for the reduced commodity rate. They suggested that ensuring the aggregate of gas flows at all terminals matched the

sum of the offtake quantities should suffice.

One respondent (DW) believed the tariff to be discriminatory to small loads.

Transco comments :

The optional NTS tariff will be available to both firm and interruptible contracts.

The basis for proposing the tariff was a desire to reflect the total costs incurred in transporting gas short distances. Where gas is sourced from elsewhere, we believe the standard rate is appropriate.

Regarding the issue of discrimination, as explained in the consultation paper, we intend that the tariff should be available to all Daily Metered loads, regardless of load size. We do not believe this to be discriminatory.

3. Summary of Transco's Revised Proposals

In line with the strong support for the proposals from many of the respondents, and the lack of any significant opposition, Transco proposes to offer the Optional NTS commodity tariff as an alternative to the NTS uniform commodity rate as soon as possible.

However, having considered the comments received, and following further analysis, we propose to make the following revisions to the structure of the proposed function.

We propose that the average load factor used as the basis for the function should be increased from 70% to 75% to reflect the characteristics of the loads which are likely to take up the service.

This gives the following revised price function to calculate the optional NTS commodity tariff, in p/kWh :

$$1203 \times \left[(SOQ)^{-0.834}\right] \times D + 363 \times (SOQ)^{-0.654}$$

We initially suggested that we did not anticipate the optional rate for a particular site, once agreed, would need to be recalculated. Having considered this further, in the interests of consistency with general transportation charges, we propose to modify this in two respects.

Firstly, as the calculated rate for an individual load is a function of SOQ, we propose to recalculate the charge for each load on an annual basis, in line with the prevailing SOQ. For this purpose the SOQ will be defined as the registered supply point capacity in the first year of operation of a new load, and will be defined by the previous year's peak day consumption in subsequent years.

Secondly, in the interests of keeping the level of the tariff in line with current pipeline costs, we propose that the function should be reviewed at the same time as the annual review of general transportation charges, and uprated in line with an industry agreed escalator. We propose that the simplest escalator would be an RPI - X mechanism, to match the cost reduction incentives of the prevailing price control. We propose the initial value of X to be 2%, which would cause optional commodity tariff to move in line with other transportation prices, and would be a surrogate for efficiency gains in pipeline construction.