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Our Ref.
Your Ref.

30 June 2005

Dear Ms Hendriks

RE Gas Transmission – new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs)

Thank you for the opportunity to comment on this Consultation Document.

We of course recognise that the basis of charging for the use of the regulated asset base operated by Transco will be subject to review and amendment but we are extremely concerned by the implications of the proposals contained within your consultation.

Although this is primarily focussed upon the setting of the Unit Cost Allowances (UCAs) for new entry points, we agree with your assertion that the methodology should be consistent in its approach and application in order to ensure that the pricing of use of all assets is transparent and cost reflective.

If the application of a recalculation of existing UCA would lead to "very significant changes in long-run incremental costs" just two years on from the original calculation, either the process or the methodology itself appears to be fundamentally flawed.

The main objective of the establishment, in 2002, of a long-term process for acquisition of System Entry Capacity (SEC) was to provide certainty. This certainty was required for the Transporter, in terms of a commitment well into the future upon which to base planning and development of system use. The certainty was also for Users, in terms of ensuring that the SEC was available to meet their future forecast of gas deliveries and at a predictable price that was reflective of the cost allowance available to the Transporter. This was seen as a significant improvement over the short-term auctions for Entry capacity where volatile prices and unpredictable availability had been experienced.

In the three Long-Term System Entry Capacity (LTSEC) processes that have been held to date, Users have already made significant commitment to SEC, which totals several hundred million pounds in aggregate. It is known that the vast majority of this revenue emanates from St Fergus entry point. It was recognised that this probably represented an approximation of (close to) real costs as it is the most distant terminal from the major demand and was known to be a point of high demand for the capacity on the system.

Whilst it is stated that a change in the pattern of gas flows will affect the use of the system, we cannot accept that the resulting change in UCAs can be representative of actual costs in both cases.

We are of the view that there are a number of principles to be established.

Firstly, the industry needs to be clear about the methodology that is applied in calculating the UCAGs. The responsibility for undertaking this calculation and the inputs and their sources utilised must also be transparent and consistent to all Users.

Secondly, the expectations and applications of the UCAGs. This would include the basis of derivation of the reserve prices from the UCAs. This process itself would also need to address the potential for under/over recovery from the resulting application in order to ensure that Transco are able to fulfil their licence obligation to set prices in order to match their allowed revenue from various classes of asset.

Having considered the method as set out in Chapter 3, we believe that the fundamental flaw is related to the manner in which the existing capacity (TO Baseline) is treated in comparison with the calculation of incremental capacity. The manner in which UCAs, and hence reserve prices in the LTSEC process, had been set previously reflected the cost of provision of existing capacity allowing a standard rate of return. Where there were signals for incremental capacity, these reflected both the cost of provision and the higher rate of return within the pricing methodology itself.

If the UCA is to be reflective of the revenue allowed against a given asset this should be relatively consistent year on year given that neither the asset base nor rate of return are subject to significant change.

Changes in the pattern of gas flows should not have such a major effect upon the price/value of capacity unless there is a clear signal that incremental capacity will be required. This point is addressed within the price escalation integral to the LTSEC process.

Should the pattern of gas flows indicate that capacity is under-utilised this is better corrected under a pricing methodology than frequent revision of the UCA. This approach would provide for long-term stability and certainty of both product and price.

With specific reference to New System Entry Points, we recognise that these will need to have bespoke UCAGs calculated when the situation arises. Trying to limit this activity to time slots within year may be counter-productive in terms of project development and Transco workload. There is an established process for developers to signal the need for a new entry point, which would trigger the necessary processes including calculation of a new UCAG.

If a request for a new UCAG causes the re-calculation of all UCAGs, this will introduce a level of volatility where parties are likely to try and factor any such moves into their decisions as to when they commit to capacity bookings under the current UNC processes. This volatility would also extend into auctions for existing baseline capacity. This has the consequence of a further dilution of any useful signals for system requirements that may have emerged from the auction processes.

The application of cost reflective principles in "isolation" to each element of the charging regime, may not produce an overall best solution. If UCAGs are not linked to those for adjacent points in some way, it may create perverse incentives to either by-pass the NTS or divert the investment to another place.

Given these observations, we are not convinced that resetting all the UCAGs ensures that all parties are treated in a non-discriminatory way as is asserted in para. 5.21. The changes indicated by the UCAs give conflicting and counter-productive signals to Transco's planning process. Players will have made significant investment decisions relating to use of Transco's system and any potential development of alternatives. A low or zero charge at St Fergus implies that Transco want to encourage higher volumes to be delivered there, which may not be the case. Similarly the dramatic increases in charges at other sites seems perverse when judged against Security of Supply criteria.

We concur that the "high level principles" (at para. 7.4) all appear sound but we are not persuaded that these will be met by the proposed solution.

In response to the remaining questions in para 7.6:-

Bullet i) Ofgem in the role of validating of Transco's work would not pick up flaws within the process as they will not have visibility of the detail. We advocate a greater level of transparency of the process and the calculation methodology to the industry more generally. This should obviate the need for any dispute resolution if there is greater confidence in the process itself. In the event that Ofgem disagree with Transco's assessment, there is an issue to be redressed should Transco be correct.

Bullet ii) We do not consider that "one size fits all" is appropriate to all circumstances. Transco use different modelling to carry out the calculations, therefore it would seem appropriate to allow variable increment sizes, subject to Ofgem Review of the outcome. Bespoke solutions may therefore be more appropriate, particularly in the event that the approach is extended to Exit as well as Entry, where a smaller increment would be required in many cases.

Bullet iii) The lead-time to availability of incremental capacity has also been raised in the context of the Incremental Entry Capacity Release statement. We would re-iterate our view that the 3-year lead-time should remain the standard. Should there be any necessity to deviate from this in exceptional circumstances, the cause and extent of the variation must be apparent in advance of the conduct of the auction/allocation.

Bullet iv) fixing agreed timeframes should be helpful. However, limiting requests to a number of opportunities each year may not always help and could lead to unnecessary delay should one of these be missed.

Bullet v) The calculation of UCAGs should not result in a charge being levied upon the requester on the basis that the request is made in good faith and as part of the appraisal of a development. We believe that this should fall within the normal function of the NTS Transporter.

Bullet vi) As stated above, we welcome greater transparency in the process. If Users had a greater awareness of the operation of Transcost it would be helpful.

Bullet vii) Changing to an annual process may encourage parties to act in more commercial manner when deciding when to develop new opportunities. However, we re-iterate our concern about the volatility caused by the application of this methodology if this is the effect of a continuous review.

Summary

With regard to the proposed solutions contained within the consultation, we are not convinced that all issues are addressed. Making no change or partial solution now and leaving the issue until the next price control in 2007, just delays the problems. It would provide for greater certainty to identify and implement an enduring solution sooner. However, this must be on the basis of a methodology and process which enjoys the understanding and confidence of the industry. Moving to a total uncapped recalculation every year encourages people to signal requirements to Transco outside of the Auction process due to the volatility that timing of their actions and those of others can have, which further undermines the auction process.

Please contact me if you require any further information.

Yours sincerely,

Mike Young
Commercial Manager