

UKOOA POSITION PAPER ON NTS CAPACITY ISSUES

1. Introduction

The purpose of this paper is to:

- highlight problems and concerns with the current capacity regime;
- establish a clear understanding of UKOOA's position on capacity issues;
- suggest high-level solutions which will be effective in the long term; and
- emphasise the urgent need in the short term to resolve the apparent mismatch between supply and demand at individual terminals, before the longer-term arrangements take effect.

The capacity regime currently in place is still in need of fundamental reform. Although the proposals for long-term capacity auctions and output measures under Transco's new Price Control go some way towards improving the regime, important details of how they will work are unresolved and there is no definite timetable for putting these arrangements in place. As a result, the uncertainty created by the current short-term auctions continues. In addition, the significant problem of perceived constrained capacity at St Fergus is likely to persist for several years due to the long lead-time for further investment to have its effects. It is worth noting that today's upstream investment decisions result in gas delivery in two to five year's time and that new gas developments are assessed over the life of the field. Whereas historically the cost of entry capacity was largely predictable (and, being related to costs, comparatively small) through the long-run marginal cost charging methodology, the current regime of short-term auctions has introduced significant price volatility for entry capacity, thus increasing normal exploration and production risks. Such additional risk means that some marginal fields are unlikely to be exploited and that investment funds may go to other parts of the world where there is less uncertainty. Furthermore, this extra risk could possibly deter the landing of, say, Norwegian gas at St. Fergus.

2. Key Principles

In order to provide a framework for discussing capacity issues it is helpful to highlight a number of key principles that, if adhered to, would facilitate effective solutions. These principles are:

2.1 *Price Stability for Purchasers of Capacity*

Volatile prices create uncertainty when evaluating investment opportunities, whereas price stability benefits not only purchasers of capacity, but other industry participants and consumers as well.

2.2 *Transparency of Process*

Information about capacity which is available at individual entry points, how this may be affected by interactions within the NTS and the reserve prices associated with capacity provision should be readily available to all market participants in a transparent manner which allows the process by which these details are calculated to be clearly understood and replicated. Only by having such transparency can participants make informed decisions.

2.3 Certainty of Availability of Capacity for Purchasers

Purchasers of capacity need to be assured that the capacity they have paid for will be available and that the associated service is clearly defined. If the capacity is not available, Transco should bear the full cost of buying back at the market price, outside of the allowed revenue under the price control. There should also be clarity as to the circumstances under which Transco can issue a Transportation Flow Advice (TFA) rather than undertake capacity buy-back.

2.4 Appropriate Incentives on Transco to Invest

Transco needs to be given appropriate financial and regulatory incentives to invest in an efficient and timely manner and disincentives for under-investing or wrongly investing.

2.5 Investment Certainty for Transco

Transco needs certainty that, if it invests in an efficient and timely manner, it will be allowed to recover its investment in future price control periods. Without such certainty, Transco will almost inevitably continue to under-invest.

3. Overview of the Current Situation

The purpose of this section is to provide an overview of the current situation regarding both short-term and long-term capacity, as well as the issue of revenue over-recovery and, where appropriate, the UKOOA position on these issues.

3.1 Short-term Capacity Issues

- Costs of capacity at St. Fergus remain high and are inherently volatile, because of a perceived lack of capacity. Similar signs have been evident at times at other terminals. This provides a disincentive for investment in new, mainly marginal offshore fields.
- This perceived lack of capacity at St. Fergus and elsewhere largely results from the method of determining the capacity available in the auctions, prior to those for the winter of 2001-02. This method has been based on historic demand, not on what the network can actually deliver.
- Given the method which has been used, except for winter 2001-02, to determine the capacity released, the current short-term auctions do not provide soundly based supply and demand signals. Even if they did provide sound signals, however, short-term auctions would be an inappropriate means for deciding when and how much additional capacity should be built, as such investments are by their nature long term commitments.

- Similarly, entry capacity prices that are emanating from the short-term auctions lead to the sub-optimal use of the existing UKCS infrastructure, as existing supplies have no choice in their point of entry to the system and there may, therefore, be economic incentives to reduce production where possible. Similarly, prices and their volatility could divert potential supplies from the UK market.

3.2 Long-term Capacity Issues

- No long-term capacity allocation is currently in place, although Ofgem have proposed a form of long-term auction.
- Industry discussions have recently commenced. Transco's initial proposals indicate that there will be a series of one-year auctions during Q2 2002 covering the gas years 2002-3 to 2004-5. Consequently, the first genuine long-term auction, planned for Q3 2002 and, as a result of which, capacity can be increased through incremental investment by Transco to match demand, will not be effective until gas year 2005-6 at the earliest.
- UKOOA supports the principle of long-term, price-based allocation of capacity through an open bidding process for such capacity, where that bidding process identifies the requirement for that capacity and the willingness of the participants to pay for such capacity, based upon a minimum price indicated by Transco.

3.3 *Transco Revenue and Over-recovery Issues*

Current over-recovery arrangements, prior to winter 2001-02, have added further distortions to the entry capacity market, since they have not provided for neutrality between shippers in re-distributing excess income. The interim mechanism for redistributing excess income for winter 2001-02 is a step in the right direction. It has reduced both price risk for entry capacity buyers and such distorting effects, by returning excess revenue in a less discriminatory manner. Whilst UKOOA recognises that an appropriate mechanism needs to be in place to manage over-recovery, nevertheless the underlying principle for dealing with this issue should be that **avoidance is better than cure**. The provision of appropriate and efficient long-term investment signals from a long-term auction process should negate the over- or under-recovery problem to a large extent.

Recent short-term capacity auctions have led to substantial over-recovery of revenues by Transco. With effect from April 2002, Ofgem is proposing a separate price control for the NTS and, therefore, it will not be possible to re-distribute Transco's over-recovery through adjustments to non-NTS charges.

4. The Way Forward

The gas industry in the UK and, for that matter, throughout the world, has been founded on long-term investment decisions whose consequences usually stretch over 20 or 30 years, sometimes even longer. Whilst the development of competition has facilitated the emergence of short-term capacity and gas commodity markets, the underlying need for long-term investment continues, especially when security of supply is considered. Traditionally, energy

networks have had a degree of resilience built into them, to help ensure security of supply and, therefore, to protect a broader, national interest.

The risks to the UK's economy of under-investment in the NTS far outweigh the risks of over-investment.

4.1 The Short-term

Although reliable, predictable and soundly based arrangements for NTS capacity provision can only be ensured on a continuing basis by effective and timely long-term investment signals, there is a number of actions which could be taken to reduce the degree of uncertainty in the short-term and would therefore be valuable in their own right.

- The provision of further authoritative information concerning the physical capability of the NTS, its flexibilities and the interactions between flows at system entry points and between supply and demand.
- Public availability of more information about Transco's maintenance programme and its potential effects on system capability.
- Continuing review of the methodology for determining the amount of capacity to be released in the short-term auctions, so that this more closely represents the physical capability of the NTS rather than tracking historic demand.
- Early establishment of a means of redistributing any over-recovery of income by Transco which is neutral between market players and so avoids any distortion of bidding behaviour.
- A review of possible alternative auction methodologies to consider whether a truer reflection of actual supply and demand could be obtained by adopting a different auction design.
- Active consideration of any possibilities for increasing capacity availability through short-term network enhancement projects, bearing in mind that any such investment would have a minimal impact on transportation costs.

4.2 The Use of Long-term Auctions

UKOOA believes that the ultimate solution to the NTS capacity constraint problems, both at St Fergus and elsewhere, may be found in the use of **long-term auctions which take account of both price and volume variations**. While it is not the intention of this paper to develop the detail of these proposals, the following points need to be highlighted:

- All capacity should be made available on a long-term basis (at least 5 years). Such a bidding process should also allow shippers to bid for capacity above that in existing investment plans, since such an approach would provide Transco with market signals to provide such capacity and provide industry with the certainty of obtaining such capacity.
- Where the requirement for capacity over the auction period exceeds the current or planned capacity, then Transco should indicate a minimum price above which it would build an amount of additional capacity.
- The process should allow for a match between users' demand for capacity and the costs incurred by Transco in providing this.

4.3 *Resolving Over-recovery Issues*

UKOOA favours a neutral approach to over-recovery. One possibility is an investment fund, which in the event that over-recovery occurs, would allow Transco to undertake one or both of the following:

- Bring forward current investment plans by effectively funding the increased time value of money.
- Facilitate additional new investment to solve the problem.

4.4 *Other actions that could be taken to improve the provision and allocation of capacity*

There is also a number of secondary actions that can be taken to improve both the ways that capacity is constructed and priced, which are as follows;

- The Base Plan Assumptions process must be improved, since it is a key driver for the investment process in the short-term (at least over the next three years).
- Investment should continue to develop from being just demand driven to reflect also uncertainties regarding the source of supply. This will become increasingly important as the UK becomes a net importer of gas. UKOOA welcomes the increased flexibility that Transco is proposing to build into the system over the next five years, as described in the recent consultation document, “Transporting Britain’s Energy”, and incorporated into Ofgem’s final proposals for Transco’s next price control.
- Summer capacity is now as important as winter capacity. The 1 in 20 peak demand obligation in Transco’s licence has perhaps been allowed to obscure its wider statutory obligation “to develop and maintain an efficient and economic pipeline system”. **The 1 in 20 obligation should be reconsidered.**