Short-term Options for Vector Capacity Arrangements

Presentation to working group

September 2010

Creative Energy Consulting

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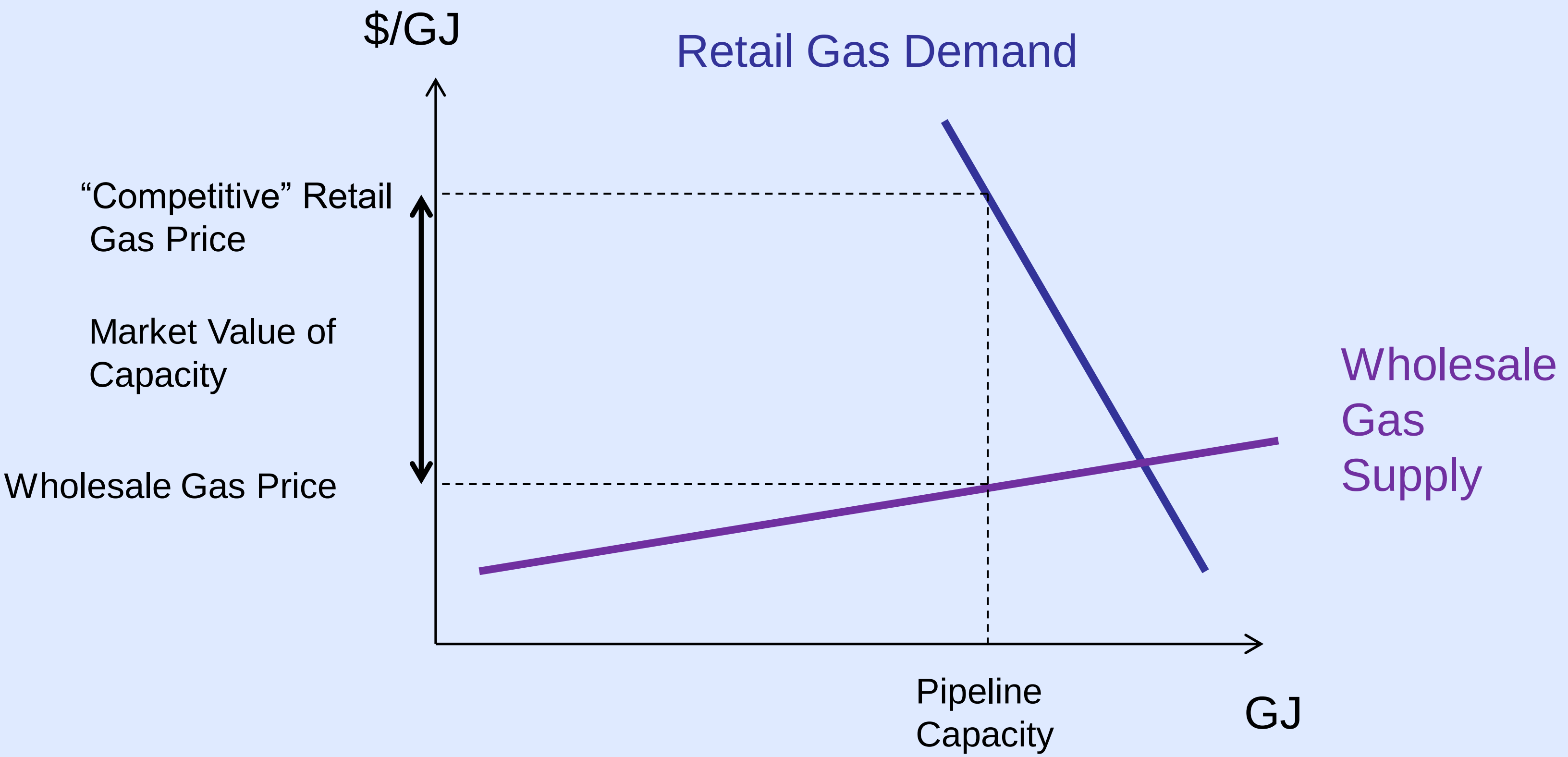
- The current situation
- Managing demand growth
- Objectives of a ST Solution
- Workshop approach
- Options and variations for a ST Solution

The Competitive Model



In a competitive market, capacity prices would be increasing anyway

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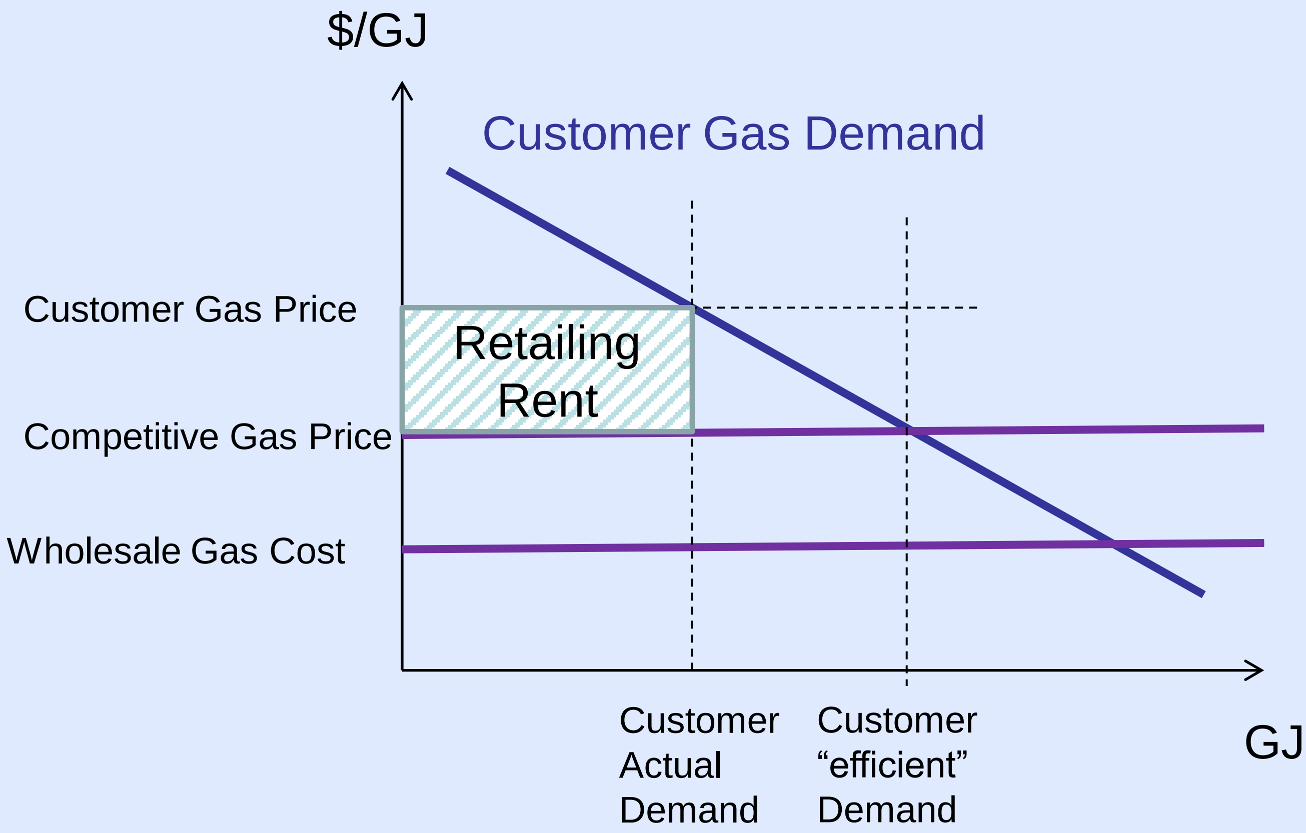
Loss of Competition



Loss of competition may lead to prices even higher than the competitive price

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Why Loss of Competition

- Retailers do not have, and cannot obtain, capacity to make competing offers to large customers
- Retailers unwilling to “drop” existing low value customers in order to serve higher value customers:
  - PR risks
  - Uncertainty about which customers low or high value
  - Uncertainty about winning high value customer
  - Contracts are multi-year, leading to slow churn
- So:
  - New retailers *cannot* serve customer
  - Incumbent retailer *must* serve customer

The Franchise Model

- Lack of competition means:
  - no other retailer can supply customer (so price can be higher than competitive level)
  - incumbent *must* supply customer (so price can be lower than competitive level)
  - In effect, each retailer has an established “franchise”
- Retailer aims to set a “franchise” price that maximises retail rent:
  - (price – cost to serve) x customer demand
- What is capacity “cost to serve”?
  - If hoarded anyway, and no other uses, then cost=0
  - If would be rescinded, then cost=CRF
  - If could be used to supply other customer, or sold on 2ndary market, then cost =capacity price
- Franchise price may be higher or lower than competitive price
  - So retailing rent might be positive or negative
- So, freeing up competition may lead to:
  - higher prices for “low value” customers
  - lower prices for “high value” customers

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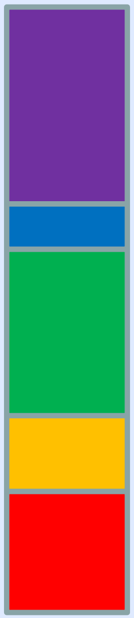
Components of Customer Price



Retailing Rent = Actual Retail Price – Competitive Retail Price

Retailing Cost

Capacity Rent = Capacity Price – Capacity Costs

Capacity Costs = CRF + Throughput Fee

Wholesale Gas Cost

Freeing-up competition will remove retailing rent
Increasing capacity will remove capacity rent

Demand Growth

- In the competitive model, the high capacity price suppresses demand growth:
  - New customers will be discouraged
  - Existing customers may cut back usage
- In the “franchise” model, new customers cannot obtain supply:
  - Incumbents use grandfathered capacity to serve existing customers
  - New retailers cannot obtain capacity
- If a ST solution removes these barriers to growth then:
  - EITHER a replacement barrier must be applied:
  - OR there will be increased demand, and possible increased curtailment

An Alternative Entry Barrier

- In competitive model, the barrier is *price* based;
- In franchise model, the barrier is *retailer* based;
- In this alternative model the barrier is *customer* based
- Alternative model applies to:
  - all “large” customers above specified threshold
  - existing and prospective large customers
- Retailers not permitted to supply:
  - Prospective large customers at all
  - Existing large customers above historical level (unless previously notified)

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Objectives of ST Solution

- Free up retail competition:
  - Retail prices converge to “competitive price”: more efficient use of scarce capacity
  - Improved competition/efficiency in wholesale gas and retailing markets
- Reduce retail gas prices
  - If prices are higher than the “competitive level”; or
  - If competitive prices are considered too high for a short period (due to investment issues), creating instability and dynamic inefficiency
- Preserve competitive value of grandfathering rights
  - Essentially, this is the value of the “capacity rent” that they confer
  - Regulation should seek to avoid unnecessarily interfering with property rights
- Quick to Implement
- Minimise Price/Revenue shocks
- Minimise Curtailment
  - Users expect and rely on firm service
  - Curtailment is necessarily inefficient: it rations practically rather than economically

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Workshop Approach to Developing ST Options

- Based around 3 basic options (see following slides)
  - And any other basic options proposed at workshop
- Discussions framed around possible *variations* to each option (see following slides)
- Discussions informed by the ST objectives
- Workshop objective:
  - To have defined 3 (or perhaps more) coherent options which best achieve the ST objectives
  - To have an understanding of the strengths and weaknesses of each model in terms of the ST objectives
  - But NOT to have agreed on the preferred model (unlikely to achieve this anyway)

The 3 Basic Options

- Vector to issue new capacity (“new capacity”)
- Existing capacity follows customers (“transfer capacity”)
- Common Carriage

Variations on New Capacity

- Under what circumstances should new capacity be issued:
  - Only where required to make competing offers for large customers? What is “large”?
  - Unlimited
  - Other?
- How much capacity should be issued?
  - Defined by reference to particular customers? How?
- Is the alternative entry barrier required?
  - If so, what is the threshold for “large” customers
- What are the terms of capacity?
  - Standard reserved capacity? Transferable? Term? Grandfathering?
- What is the price?
  - CRF, “competitive price”, expansion cost, other?
- Any other variations?

Variations on Transfer Capacity

- Threshold for “large” customers
- Defining amount of capacity to be transferred
  - Customer MDQ
  - Retailer “requirement”
- Must “gained” capacity be equal to “lost” capacity?
- Price of transfer:
  - CRF, other?
- Practical issues
  - Notification
  - Timing of determination of capacity amount
- Any other variations?

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Variations on Common Carriage

- Basis for tariffing
  - Retailer coincident peak demand,
  - Retailer non-coincident peak demand
  - At pipeline level or delivery point level?
  - Length of “peak” (eg average of 10 highest demands etc)
- Level of tariff
  - CRF, with scaling to preserve Vector revenue?
  - CRF pricing methodology, adapted as needed
  - New pricing methodology required?
- Cashflow management
  - Provisional charges based on forecast demand?
- Alternative Entry Barrier needed?
  - What is large customer threshold
- Any other variations?