MEMORANDUM

TO: Pipeline Users

FROM: First Gas

DATE: 1 December 2017

RE: **Transmission Incentive Charge Rebates**

At the GTAC workshop on 17 November 2017, First Gas agreed to summarise its proposal to rebate transmission incentive charges under the GTAC in the month they occur. This change was given effect to by mark-ups to section 11.13 of the Second Revised Draft GTAC providing for total Daily Overrun Charges, Underrun Charges, Hourly Overrun Charges and Over-Flow Charges to be credited to shippers each month pro-rata on DNC charges to each shipper.

First Gas see three benefits from making this change:

* It directly recycles incentive charge revenue at the time the charges are incurred, rather than requiring shippers to wait until subsequent regulatory years for the revenue to be recycled (via the First Gas revenue cap wash-up account). This avoids any intertemporal issues that arise from parties entering or existing the gas industry, and provides a more direct benefit to parties that manage their transmission system use well during the month.
* It avoids the need for First Gas to forecast revenue to be earned from incentive charges in a regulatory year, which can vary considerably from year to year and are largely outside our control. This forecasting task would be particularly challenging in the first year that the GTAC applies given the lack of experience on how well parties can manage daily GTAC nominations and maximum hourly quantities at dedicated delivery points.
* It applies the same approach as proposed for recycling PR revenue, and therefore provides a consistent approach to crediting all non-DNC transmission charges pro-rata on DNC charges.

**Worked example of crediting transmission incentive charges**

The following tables illustrate how the proposed credits compare with current arrangements that recycle over-recovery of revenue, based on the scenario presented at the November workshops. The key facts in this scenario are:

* First Gas has a revenue cap of $120m per year, and expects to earn $20m from Supplementary capacity, $90m from standard capacity products, and $10m from transmission incentive charges
* For reasons unknown, shippers incur transmission incentive charges of $15m in the first year of the regulatory period ($5m higher than forecast by First Gas)
* For simplicity, this scenario ignores the effect of time value of money adjustments (which are required under the Part 4 input methodologies).

Table 1 traces through how the additional revenue earned from transmission incentive charges finds its way back to Shippers under current arrangements (and as proposed under the GTAC before the recent changes). In effect, the additional $5m of incentive charges is returned through lower standard transmission fees in year 3 of the regulatory period. This credit occurs in year 3 (rather than year 2) because the final revenues from transmission incentive fees are not known when prices for year 2 are set.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Regulatory Year** | | | | |
|  | **1** | **2** | **3** | **4** | **5** | |
| Supplementary capacity | 20 | 20 | 20 | 20 | 20 | |
| Standard transmission capacity (DNC) | 90 | 90 | ~~90~~ 85 | 90 | 90 | |
| Transmission incentive charges | ~~10~~ 15 | 10 | 10 | 10 | 10 | |
| **Total revenue** | **~~120~~ 125** | **120** | **~~120~~ 115** | **120** | **120** | |

The proposed approach under the GTAC would see First Gas’ allowable revenue recovered from supplementary and standard transmission capacity charges, with transmission incentive fees rebated throughout the year. This is shown in the two tables below. First Gas would forecast no revenue from transmission incentive charges, since any revenue earned from these charges will be credited back to shippers. The $15m of incentive charges that would have been charged in year 1 of the regulatory period (circled in red) has been credited throughout the year (shown in the second table below). So rather than the high incentive charges in August of that year being treated as revenue by First Gas, the funds are rebated to all shippers pro-rata on DNC charges).

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Regulatory Year** | | | | |
|  | **1** | **2** | **3** | **4** | **5** | |
| Supplementary capacity | 20 | 20 | 20 | 20 | 20 | |
| Standard transmission capacity (DNC) | 100 | 100 | 100 | 100 | 100 | |
| Transmission incentive charges | - | - | - | - | - | |
| **Total revenue** | **120** | **120** | **120** | **120** | **120** | |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Incentive fees | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
| Charged | 0.5 | 0.5 | 0.5 | 0.5 | 1 | 1 | 1 | 4 | 2 | 2 | 1 | 1 |
| Rebated | -0.5 | -0.5 | -0.5 | -0.5 | -1 | -1 | -1 | -4 | -2 | -2 | -1 | -1 |

**Concerns raised on the rebate proposal**

Submissions on the Second Revised Draft GTAC raised concerns that rebates might:

* Favour larger shippers
* Distort the incentives under the GTAC, including to ensure accurate daily nominations and the need to procure Priority Rights
* Require changes to downstream gas contracts that result in the rebates not being passed through to end-users of gas.

We have considered these concerns and provide a response in the following paragraphs. We conclude that the proposed form of rebates is unlikely to have the claimed effects, and any such effects would in any case be outweighed by the benefits described above. We do consider, however, that (if implemented as currently proposed) rebates of transmission incentive charges should be reviewed after they have been implemented to evaluate their impact.

We do not believe that the proposed rebates favour larger shippers any more than the current recycling of transmission incentive charges via the First Gas revenue wash-up account. This is because (ignoring supplementary capacity) the revenue earned from standard transmission charges and incentives needs to equal the revenue cap. If First Gas under-forecasts incentive revenues in year 1, then standard transmission fees (i.e. DNC) will be higher in year 1 and lower in year 3 (as shown above). These standard transmission fees are the measure that is used to pro-rate the rebates under the GTAC – which means that all parties will receive the same amount of incentive charge rebates under the code, regardless of their size.

We also do not consider that rebates distort the incentives under the GTAC. We accept that to be non-distortionary, rebates should be recycled against something that the party will not change due to the existence of the rebate. In our view, this makes DNC the ideal candidate for not distorting decisions – a point that was explained in our “GTAC Emerging Views on Detailed Design” paper in relation to recycling revenue from PR auctions (on p21). Submitters generally agreed with our proposal for refunding PR revenue. While there are differences between transmission incentive fees and PRs, in our view the same logic applies to transmission incentive charges.

In its most recent submission, Trustpower raised the specific concern that interactions between PRs and the proposed rebates might create distortions (see Appendix D of the Trustpower submission). We consider that the fact scenario described by Trustpower would result in different outcomes that those hypothesised. This is because the rebate of incentive charges will be based on total DNC across the system, not just the DNC charges paid at a particular location. We do not expect a shipper to ever be comfortable paying higher incentive charges due to the prospect of receiving some of it back via a rebate, since the majority of that revenue will in fact be credited to other parties. We also don’t expect the existence of rebates to change a party’s willingness to pay for PRs, since they will pay a multiple of the DNC charge at congested locations if their requests for DNC are curtailed.

In response to the final point listed above that rebates may not being passed through to end-users of gas, we do not have sufficient knowledge or understanding of those contracts to say with certainty how rebates will be passed through (if at all). However, we are comforted by the fact that the proposed rebates will be transparent and known to end-users. How the rebates are ultimately passed through will then be the subject of negotiation between shippers and end-users, most likely as part of renegotiating their contracts to align with other elements of the new code arrangements.