URGENT Modification Report
Cancellation of the auction of tolerance service
Modification Reference Number 0440

Version 1.0

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.9.3.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because on 4 August 2000, Ofgem approved modification proposal 0411 : Postponement of Tolerance Auctions. This modification proposed that the introduction of the tolerance service should be delayed until 1 April 2001 with tolerances being auctioned in February/March 2001.

In approving the modification Ofgem outlined its concerns with the current tolerance regime indicating that some shippers were using tolerance as an alternative to trading out imbalances. Further, Ofgem indicated its preference for the introduction of a linepack service that would eliminate any commercial incentives on shippers to adopt end of day imbalance positions and which would provide shippers with access to system flexibility. Ofgem also outlined its concerns at the degree of within day profiling activity occurring on the National Transmission System.

In this context, Ofgem accepted the modification on the basis that delaying the tolerance service would allow industry participants further time to consider reforms of the gas balancing regime including the introduction of a linepack service and the development of proposals for better within-day information and cost targeting.

Given the current time scales for the proposed introduction of tolerance auctions in February/March 2001, Ofgem believes that modification 0440 should be granted urgent status. In particular, should the auction be cancelled as a result of any acceptance of the modification Ofgem believes that shippers and Transco should be given sufficient notice to enable them to avoid incurring unnecessary costs, including systems development costs.

Further, granting urgency to this modification will provide the industry more time to assess the commercial implications of Ofgem's decision on the modification and take whatever actions they deem necessary.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

Proposal issued for consultation	29 November 2000
Close out for representations	13 December 2000
Final report to Ofgem	19 December 2000

1. The Modification Proposal

The changes introduced by modification 0373 regarding tolerance auctions due for implementation in April 2001 would be removed from the Network Code. The legal text is currently identified as for 'Future Implementation'. The relevant sections to be withdrawn from future implementation are in respect of; Section E, paragraphs 9 and 10; Section F, paragraphs 1.3.1, 1.3.2, 2.2.1, 2.2.2; Section V, paragraph 3.3.2.

2. Transco's Opinion

Transco supports the intent of this proposal and agrees that cancellation of the tolerance auction could be desirable. The energy balancing regime has been considerably developed since the tolerance service, envisaged within Modification 0373, was proposed. There are some concerns that provision of the tolerance service in its current form may no longer be consistent with Transco's relevant objectives. In particular, there are concerns about the complexity of the auction and also that the continued availability of imbalance tolerances may be hindering the development of markets. Transco supports continued debate of energy balancing issues including the development of a linepack/inventory service. Transco sees merit in the cancellation of the tolerance auction while a wider review is undertaken.

Transco has built a system to provide tolerance auctions. However, the RGTA system specification has advanced since the build and it would be necessary to undertake considerable work to update the tolerance auction tool. Transco believes that systems development resources would be better applied to other potential changes within the energy balancing regime.

3. Extent to which the proposed modification would better facilitate the relevant objectives

The proposer stated "Since modification 0373 was implemented, there has been limited consideration of the implications of the operation of the new service, the auction process, revenue recycling and the impact of NETA go live. In light of recent experience, both of the capacity auctions (where 3 shippers secured 66% of capacity at St Fergus), the limited trading of capacity and the operation of the market generally, the tolerance service does not seem consistent with Transco's relevant objectives. By making this change the risks of creating additional market distortions and possibly adding to the price of delivered gas, a notable concern of the DTI, are removed."

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

Transco believes that implementation of this proposal, coupled with the changes to the tolerance regime that are already contained within the Network Code, would enhance operation of the System. Transco anticipates that the removal of imbalance tolerances would enhance incentives for shippers to achieve a balance and therefore would reduce the requirements for Transco to intervene in a role as residual balancer.

b) development and capital cost and operating cost implications:

Costs have been incurred in developing the tolerance auction system. Implementation of this proposal would avoid the need to perform an update and further testing of the system. Therefore, implementation would avoid further capital and operating costs being incurred.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

Not applicable.

d) analysis of the consequences (if any) this proposal would have on price regulation:

Revenues from auctions of tolerance would be treated as NTS transportation revenue and would thus be considered with revenues from auctions of monthly capacity. Where the revenue recovered in these auctions differs from the forecast revenues for NTS services the difference is returned/recovered from Users through an adjustment to the NTS commodity charge. Cancellation of the tolerance auction would remove one potential source of under/over-recovery adjustment from the calculation of the NTS commodity charge.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

It is anticipated that implementation of this proposal would lead to a reduction in the level of contractual risk faced by Transco as shippers will face enhanced incentives to achieve a balance between inputs and off-takes.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

Implementation of this proposal would remove the need for Transco to undertake an upgrade and re-testing of the RGTA systems to provide tolerance auction functionality. Transco has not been made aware in representations of any implications for User's systems.

7. The implications of implementing the Modification Proposal for Users

Users would not have access to imbalance tolerance other than that provided for under the NDM forecast deviation adjustment. This would increase the potential exposure that shippers face of SMP cash-out exposure. Users would not participate in tolerance auctions in February 2001.

8. The implications of implementing the Modification Proposal for Terminal Operators,Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

No such implications are envisaged.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

No such consequences are anticipated.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages;

Simplifies regime, costs reduced
Removes uncertainty regarding auction of tolerance

Disadvantages;

Increased exposure to SMP cash-out
Lack of market based mechanism to allocate tolerance

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

There were 13 representations submitted in response to this proposal, of these, 9 supported the proposal and 4 did not support it. Issues identified in representations are considered below under the following headings; Auctions and revenue flows, Increased risks for shippers, Alternative services and interim proposals.

Increased risks for shippers

BP argues that it believes this proposal will introduce significant risk to shippers as they will not have the opportunity to acquire the necessary tolerances required to manage their daily portfolios following the introduction of a zero (ITQ/ATQ) tolerance regime. Northern Electric and Gas Limited (NEAGL) does not support the proposal as it believes that no tolerances as of 1 April 2001 would create an environment of increased operational risk that could potentially disadvantage the smaller shipper. Amerada is also concerned that there will be a reduction in balancing tolerances on 1 April 2001, and it believes that the approval of Modification 440 should be subject to a postponement of any further reduction in balancing tolerances.

Shell Gas Direct considers that the tolerances included in the Network Code are as valid now in dealing with unmanageable risks as they were when tolerances were first introduced and that it is not appropriate to remove these tolerances completely. Shell further argues that this modification should only be accepted on the understanding that a complimentary modification will ensure the existing arrangements are maintained.

Alliance is concerned that if implemented, this modification will increase risk and therefore impose greater costs on smaller players without significant levels of within day flexibility. Shippers that currently have the ability to profile are to a great extent protected by their ability to get themselves back into balance for the end of the gas day.

Alliance argues that it has constantly stated over the last 2 years that there should not be any further reduction in balancing tolerances until the introduction of a full tolerance or linepack service. This would allow shippers to buy a tolerance that fits their own requirements. Alliance had understood that any further reduction in tolerances would be linked to implementation of a tolerance or linepack service and it therefore considers it highly inappropriate at this stage to raise a modification that cancels the tolerance auctions.

Aquila is of the opinion that some shippers have tolerance quantities far in excess of what can be considered necessary to cope with the "uncertainties of demand and supply". Tolerances give these shippers an incentive to take an imbalance position. Moreover, Aquila does not believe that a "safety net" for demand and supply "uncertainties" should be provided by Transco. Managing such uncertainty is the function of a traded market: if shippers need SMP protection they can buy physical flexibility or financial productions that mitigate such risk *in the market.* The provision of "free" shelter from SMP cash-out, has distorted competition in the within-day gas market and reduced the efficiency of system balancing arrangements. Aquila states that tolerances should be removed as soon as possible and it would like to see them go on 1 January 2001.

BGT argues that although it accepts that it is not possible for shippers with beach inputs and/or end-user demand to achieve a zero balance and thus mitigate SMP exposure completely, it should be possible for shippers to manage this exposure to within acceptable levels.

Transco response
Transco acknowledges that the removal of the tolerance auction coupled with the removal of the current ITQ regime might expose shippers to additional risk of SMP cash-out. However, Transco also has concerns that tolerances are apparently being used for purposes other than basic risk mitigation. The changes to the ITQ and ATQ calculation are agreed within the Network Code and are out of scope for this proposal. Transco would welcome further debate on whether the Network Code energy balancing regime should allow any form of imbalance protection until other market based solutions are available.

Auctions and treatment of revenues
TXU Europe Energy Trading Ltd supports this modification as it feels that the implementation of a tolerance service would lead to increased costs to the industry, for what would be an interim period. It agrees with the issue raised in the proposal regarding time spent correcting potential problems found in the auction service when time could be spent developing a linepack service.

Scottish and Southern Energy (SSE) argues that the costs for shippers and Transco in managing the auction of tolerances seem to far outweigh the benefits, especially when it is anticipated that this would be an interim solution pending the implementation of a linepack service. In addition SSE is concerned that the auctioning of tolerances at this stage would add an additional layer of complexity to the regime that is not beneficial to competition in

shipping and supply or in the best interests of customers. It will not resolve concerns that shippers are using tolerances as an alternative to trading out imbalances.

SSE also argues that applying the capacity style model to tolerance auctions seems imprudent when it has been demonstrated that it has led to distortions in bidding. It points out that if there are no restrictions on maximum tolerance holdings; a player could have scope to purchase a considerable volume, if not all, of the tolerance and it questions whether this would be a more efficient allocation of shipper imbalance tolerances than the current method.

Although NEAGL does not support 0440, it has concerns regarding the number of `auctions' the industry faces and the associated administration and operational burden that this places upon shippers.

Shell Gas Direct believes that there is a need for the community to fully consider the potential impacts of changing the existing tolerance arrangements, the way the auctions might be conducted and the effect of the revenue recycling that will occur after the auctions. It agrees, therefore, that it is consistent with Transco's relevant objectives to cancel the proposed auctions while such issues remain to be addressed. The proposed cancellation can help the industry avoid inefficient disorder and will avoid the distortions that Shell is concerned could otherwise result from the proposals, as they currently stand.

Transco response
Transco has stated that the tolerance auction functionality would require updating and re-testing to bring it in line with the other auction types within the RGTA system. Transco does not believe that this would be an efficient use of resources while imbalance tolerance auctions are considered to be an interim step towards other services. Therefore, Transco welcomes the support for this proposal and would welcome discussion of alternative services.

Alternative services and interim proposals
TXU argues that with tolerances potentially falling to zero on 1 April 2001 the removal of the tolerance auctions may provide the necessary incentive for the industry to develop a longer term linepack service that will allow Transco to better fulfil its relevant objectives.

The proposer, Dynegy argued in the proposal that it believes that the introduction of the tolerance service, as an interim regime to be replaced by a linepack service, is not an efficient use of resources, and contrary to the operation of an efficient and economic regime. This modification allows industry resources to be better deployed securing agreement on a linepack service and examining other measures to improve the efficiency of the gas market. If the service were introduced in April, then shown not to work, the community would be forced to focus on reforming it quickly rather than looking to longer term development of the regime.

Innogy argues that it is "premature to remove the possibility of providing a tolerance service from 1 April 2001. There will always be uncertainty in balancing shipper inputs and outputs.

While flexibility tools to manage this uncertainty may exist, it is not clear that they represent a preferable option to manage the exposure to SMP cash-out. Indeed, it is hard to see how one might evaluate the alternative sources of flexibility and encourage alternative sources without understanding the relative costs."

Currently, Innogy does not necessarily see the sale of linepack and tolerance services as mutually exclusive. Given the diverse portfolios held by shippers, it may be that the tolerance and linepack services will be valued differently by shippers who face different problems in balancing their positions. This optionality should not be removed by moving straight to a linepack service without at least evaluating a tolerance service.

Whilst Alliance agrees that the tolerance service may not be the optimal solution to provide flexibility to the community in the longer term, the tolerance service has only ever been viewed as an interim solution until the industry spends the appropriate time on developing a linepack service.

Aquila argues that by auctioning tolerance, "Transco would be auctioning a financial product that provides shippers with insurance against SMP cash out. Transco need not be the vendor of such a risk management product. Indeed, this is perhaps not a service that the monopoly system operator should be selling at all".

The issue of tolerance has often been discussed in conjunction with discussions about the development of a physical linepack market. Aquila strongly supports the creation of a physical linepack market. Whether this market is created in April 2001, October 2001 or any other date has no bearing on the tolerance issue.

Powergen argues that it does not believe that there is any current need to introduce a linepack service or introduce further modifications in Spring 2001, especially when Ofgem and many players will be focusing on implementation of NETA. It would welcome time to assess the implications of operating under a zero tolerance regime before implementing new services.

Scottish Power also argues that it would prefer a measured approach to the development of the linepack services rather than a “quick fix”, but would also like to see adequate time and resources committed to negotiations on the development of a linepack service over the next few months.

Transco response
Transco notes that a linepack or inventory service is anticipated by some to be a better solution that would provide an appropriate market based mechanism for shippers to manage imbalance risk. The delivery of such a service would require a significant systems development and testing programme. Transco would welcome early discussions on the form of such services so that the nature of the systems changes could be identified to ensure that development effort is not wasted.

Transco believes that there may be alternative means for shippers to mitigate the risks of cash-out at SMP prices and that not all of these rely on access to physical gas flow flexibility. The implementation of this proposal may stimulate development of alternative risk management tools that could enhance the competitive gas market.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Not applicable

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Not applicable

14. Programme of works required as a consequence of implementing the ModificationProposal

No programme of works is required as implementation of this proposal would cancel the introduction of new system code.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Implementation is required before up-load of new auction system code onto the RGTA system.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that the appropriate sections of Modification 0373 are removed from the Network Code so that the tolerance service is not implemented from 1 April 2001. For clarity Transco wishes to identify that Modification 0373 was subsequently amended before implementation by Modification 0411. The effect of Modification 0411 was to postpone the proposed changes in respect of Sections E, F and V until 1 April 2001. However, the changes to Sections C and D agreed under Modification 0373 were implemented on 1 October 2000.

The implementation of this proposal would prevent the changes that were identified within Modifications 0373 / 0411 from coming into effect.

17. Text

No legal text is provided as the effect of this proposal is to prevent the implementation of text agreed under Modification 0373.

For the avoidance of doubt, the modified text implemented under Modification 0373 and subsequently deferred by Modification 0411 and identified as "Future Implementation" in respect of the follow paragraphs, will be removed from the Network Code. The effect of this will be as follows;

Section E, paragraphs 9 and 10, (Section will not renamed, new paragraphs will not be inserted)
Section F, paragraphs 1.3.1, 1.3.2, 2.2.1, 2.2.2 (amendments will not be made)
Section V, 3.3.2(iv) (amendment will not be made)

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Gas and Electricity Markets Authority Response:

> In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0440**, version **1.0** dated **19/12/2000**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:

Process Manager - Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:

   (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or

   (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

   provided that if the Authority does not so approve the Agreement then Clause 3 shall apply.

2. If the Authority does so approve this Agreement in accordance with the terms of the Order (whether such approval is actual or deemed by effluxion of time) any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.

3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, had it not been repealed, would apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) or 2(2)(b)(ii) of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.

4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.