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Direct Dial: 020 7901 7374

24 September 2002

Your Ref:  
Our Ref : Net/Cod/Mod/552

Shippers, Transco and Other Interested Parties

Dear Colleague,

**Network Code modification proposal 552 "Removal of the Incentivised Nomination Tolerance Quantity"**

Ofgem has considered the issues raised in Network Code modification proposal 552 "Removal of the Incentivised Nomination Tolerance Quantity". Ofgem has decided to direct Transco to implement the modification. We consider that the proposal will better facilitate the achievement of the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal, the nature of the proposal, summarise respondents' views, summarise Transco's views, give reasons for Ofgem's decision and confirm the decision.

**Background to the proposal**

On 2 May 2002, Ofgem directed Transco to implement Network Code modification proposal 511 "Removal of NDM Forecast Deviation from Imbalance Calculations" from 1 October 2002. This modification removes the tolerance for shippers for imbalance quantities that arise from differences between shippers allocated NDM demand and Transco's NDM demand forecasts. Imbalance volumes within the tolerance are cashed out at System Average Prices, while all other imbalance volumes are cashed out at System Marginal Prices.

On 23 May 2002, Ofgem directed Transco to implement Network Code modification proposal 479 "Incentivised Nomination Scheme". Transco decided that it was appropriate to implement the proposal from 1 October 2002. Under Network Code modification 479, shippers nominated imbalance positions (the difference between shippers physical inputs and offtakes, net of trades, on Transco's National Transmission System (NTS)) at 02:00 D-1, 12:00 D, 18:00 D and 22:00 D would be compared to their allocated imbalance at the end of the gas day. If there was a difference between a shipper's nominated imbalance position at the four pre-defined

times and a shipper's end of day allocated imbalance greater than the shipper's NDM forecast demand deviation tolerance, the shipper would face a charge. The charges would only apply on those days when Transco took a balancing action.

Under Network Code modification 479, shippers do not face a charge for volumes covered by the NDM demand forecast deviation tolerance, which would be removed by Network Code modification 511 for imbalance cashout from 1 October 2002. This is called the 'Incentivised Nomination Tolerance Quantity' (INTQ).

Network Code modification proposal 563 "Delay to the removal of NDM Demand Forecast Deviation Tolerance" proposes that the implementation of Network Code modification 511 be delayed until October 2003.

This month Network Code review group 567 "Review of NDM demand forecasting methodology" was set up to consider what changes are necessary to allow shippers to better forecast demand for their NDM portfolios and to manage the risk of demand forecasting errors.

### **The modification proposal**

Network Code modification proposal 552 proposes that the INTQ is removed from the INS imbalance calculation from 1 October 2002.

### **Respondents' views**

There were ten responses to the consultation. One shipper supported the removal of the INTQ, two shippers offered qualified support and seven respondents did not support the modification proposal.

One shipper argued that while some shippers may be able to better forecast NDM demand than Transco, there was no mechanism for shippers to inform Transco that they were not tracking its demand forecasts, and therefore it did not see how removing the INTQ would improve the economic and efficient operation of Transco's system. Some shippers argued that the lack of a mechanism for them to notify Transco that they were not following its demand forecast could lead Transco to take unnecessary balancing actions. A shipper argued that it would be difficult for Transco to interpret the INS nominations if INTQ was removed.

Four shippers argued that the INTQ was appropriate because shippers could not effectively mitigate the effects of within-day changes in NDM demand.

Two shippers believed that the operation of INS had been on the basis of an INTQ, and its operation should be assessed, before making further changes. Two shippers specifically sought consistency in the conclusions and the timing of introduction of Network Code modification

proposals 552 and 563. Two shippers believed that the status of INTQ should be considered in Network Code review group 567.

One shipper believed that it was inappropriate for shippers with NDM loads to face different incentives than shippers with DM loads, who do not benefit from the INTQ. It argued that maintaining the INTQ would unduly discriminate between different classes of shippers and would not facilitate the objective of promoting competition between shippers.

One shipper argued that the INTQ should be an absolute quantity rather than a proportion of a shippers NDM demand, so as not to unduly favour large shippers.

#### **Transco's view**

Although Transco proposed the modification, it believed that while the arguments were finely balanced, it recommended that the proposal should not be implemented.

Transco stated that if uncertainty for shippers with NDM nominations was due primarily to NDM demand uncertainty then removal of the INTQ might be considered appropriate. However, if the uncertainty is primarily driven by other considerations, then Transco believed that the INTQ might be appropriate to give shippers with NDM loads appropriate protection.

Transco stated that the removal of the INTQ would increase the incentive on shippers to maintain and achieve initial INS nominations. This, together with the imbalance cashout regime, could be expected to improve shipper balancing, which might reduce Transco's residual balancing role.

Transco also stated that it was possible that the removal of the INTQ would increase the prevalence of shippers making late flow rate changes to minimise exposure to INS charges. It argued that while the NDM demand forecast deviation tolerance remained, this effect might be modest, but that Transco would have greater concerns about late flow rate changes if INTQ was removed.

#### **Ofgem's view**

Ofgem has not consented to the implementation of Network Code modification 563 because we do not believe that it better facilitates the achievement of the relevant objectives of Transco's Network Code. Ofgem believes that many of the factors that were relevant to considering that modification proposal and Network Code modification proposal 511, are also relevant to considering Network Code modification proposal 552.

As stated in Ofgem's decision letter for Network Code modification 511, we believe that the removal of the NDM demand forecast tolerance would provide shippers with better incentives

to manage imbalance risks because all imbalances would be cashed out at System Marginal Prices. Ofgem explained that it believed that competition between shippers would be better facilitated because to the extent that some shippers were better able to forecast demand than other shippers or Transco they would obtain a commercial advantage. Ofgem also stated that the tolerance may constitute a cross subsidy from shippers at DM sites to shippers at NDM sites because shippers at DM sites do not have any tolerance. We believe that these arguments also apply to consideration of the INTQ.

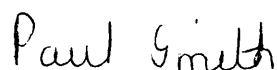
Ofgem considers that, in general, it would be appropriate to ensure consistency between the use of tolerances for imbalance cashout and INS charges to ensure that shippers' incentives are aligned. However, Ofgem recognises that shippers will have prepared for INS on the basis of including an INTQ. Therefore, while Ofgem believes that the implementation of Network Code modification proposal 552 would better facilitate the achievement of the relevant objectives of Transco's Network Code for the reasons set out above, we consider that it is appropriate for shippers to have sufficient time to prepare for the introduction of INS without the INTQ. Therefore, while consenting to this modification proposal, Ofgem believes it should not be implemented until 1 April 2003.

#### **Ofgem's decision**

Ofgem has decided to consent to this modification, as we believe that it will better facilitate the achievement of the relevant objectives of Transco's Network Code. We believe the modification should be implemented from 1 April 2003.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Ayesha Uvais on 020-7901-7307.

Yours sincerely

A handwritten signature in black ink that reads "Paul Smith". The signature is written in a cursive, slightly informal style.

**Paul Smith**  
**Head of Market Surveillance**