

Modification Report
Removal of the Incentivised Nomination Tolerance Quantity
Modification Reference Number 0552
Version 2.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

It is proposed that the INTQ (Incentivised Nomination Tolerance Quantity) feature is removed from the Network Code. This would involve the removal of the INTQ term from the calculation of a User's Forecast Performance Measure.

2. Transco's Opinion

Modification Proposal 0479 "Incentivised Nomination Scheme" (INS) will be implemented from 1st October 2002. The scheme includes the Incentivised Nomination Tolerance Quantity (INTQ) that is designed to prevent User exposure to INS charges that might otherwise arise from the differences between a User's aggregate NDM nomination prevailing at each INS assessment time and its aggregate NDM allocation. Removal of the INTQ would therefore increase INS charges for Users with an NDM portfolio under some circumstances.

INS is designed to encourage Users to provide the best possible projection of their end of day imbalance. In order to do this Users will need to take account of projections of their physical gas supply inputs, their net traded position and their physical offtakes (both DM and NDM). INS has been designed recognising that Users may have considerable scope to amend gas supply inputs, net traded positions and DM demands which may change their imbalance position. However the NDM demand attributed to individual Users will be determined by the aggregate behavioural response of NDM consumers (particularly with respect to weather) and the demand attribution process.

Transco recognises that implementation of this Proposal may increase risks to Users given the uncertainty of NDM nomination accuracy. Such uncertainty arises from a number of sources including those genuinely associated with NDM demand but also those which arise from inaccuracies in total and DM sector load projections.

If the uncertainty associated with NDM nominations is primarily driven by NDM demand unpredictability then removal of the INTQ might be considered appropriate. However, if the uncertainty is primarily driven by other considerations, then the INTQ might be considered to provide appropriate protection to Users with NDM load.

The removal of the INTQ would increase the incentive on a User to maintain its initial INS nomination and achieve such a nominated imbalance position. In combination with the imbalance cashout incentive this might be expected to improve User supply/demand balancing. This might reduce supply/demand variances, thereby reducing Transco's residual system balancing role. Particularly early in the Gas Day this might be expected to improve system stability.

It is possible that the removal of the INTQ would increase the prevalence of Users making late flow rate changes to minimise their exposure to INS charges. Whilst the NDM Forecast Deviation remains a feature of the imbalance regime this effect may be modest. However, should this be removed, Transco may have greater concern about the late flow rate changes that might be engendered by removal of the INTQ.

Transco therefore concludes that whilst the arguments are finely balanced the INTQ should be retained. As such, Transco recommends that this Proposal should not be implemented.

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

Removal of the INTQ would result in full exposure of any difference between a User's projected imbalance, via the INS Nominations at each INS Forecast Daily Imbalance Time, and its allocated imbalance to the relevant proportion of the SMP - SAP price differential. Such increased risk exposure may generate additional risk mitigation costs. If Users are able to develop more accurate NDM demand forecast than those generated by the demand attribution process then Users would be able to reduce their INS exposures.

To the extent that such changes do not impose inappropriate costs, the Proposal may be consistent with facilitating competition between relevant Users, as stated in Standard Condition 9.1 (b).

However, it is not clear whether the Proposal will further the relevant objective of "efficient and economic operation" as stated in Standard Condition 9.1 (a).

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

a) implications for the operation of the System:

Removal of the INTQ will result in full exposure of any difference between each User's imbalance forecast prevailing at each Forecast Daily Imbalance Time and its allocated imbalance to the relevant proportion of the SMP - SAP price differential. If a User is able to respond to the increased exposure by improving the accuracy of its projected end of day imbalance, the accuracy of Transco's forecast system balancing requirements might also be improved.

However, it is also recognised that there is the potential for adverse impacts as a result of User's attempting to mitigate the increased risk exposure.

b) development and capital cost and operating cost implications:

The INS system has been developed such that the INTQ, as currently defined, can be included or excluded from the INS charge determination algorithm with 2 days notice without incurring any additional costs.

However if alternative methodologies to provide allowance for NDM forecasting inaccuracies are to be developed, additional system development and deployment costs would be 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:

If the INTQ is removed, there will be no additional costs to recover above those for the INS system developed for Modification Proposal 0479.

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

This Proposal is not considered to have consequences in respect of price regulation.

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

No such consequences are anticipated.

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

No such consequences are anticipated.

7. The implications of implementing the Modification Proposal for Users

Transco considers that Users with an NDM portfolio would be exposed to increased INS charges under some circumstances. This might result in additional risk mitigation costs for Users should they consider that such expenditure was warranted. Users would have regard for the potential to reduce direct costs associated with INS charges in the context of the redistribution of the income accruing to balancing neutrality from the aggregate of all INS charges.

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

Transco considers that there would be no direct impact on the above parties.

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 changes to contractual relationships are anticipated.

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

Advantages:

- Increased incentives on Users with an NDM portfolio to provide Transco with their best possible projected end of day imbalance position.
- May promote the development of new NDM forecasting models and risk management tools.
- Simpler INS charge determination and verification.

Disadvantages:

- NDM demand changes within day can be difficult to predict and may be outside of User control, thereby exposing Users to inappropriate risk.
- The increased risk exposure may deter potential new entrants to the NDM market.
- By attempting to mitigate the increased risk exposure Users may be encouraged to use estimates other than the NDM nominations as the best estimate of NDM demand. This, in the absence of available information to Transco about User estimates of demand, might reduce the value of the INS nominations to Transco thereby reducing the operational benefits of INS.

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

Representations were received from the following Users:

AEP Energy Services Ltd (AEP)
Shell Gas Direct (Shell)
TXU Europe Energy Trading Limited (TXU)
London Electricity Group Plc (LE)
Scottish and Southern Energy Supply Ltd (SSE)
Innogy Plc (Innogy)
BP Gas Marketing Ltd (BP)
Powergen UK Plc (Powergen)
British Gas Trading Ltd (BGT)
Agip (UK) Ltd (Agip)

Of the representations received one supported the Proposal (BGT), two provided qualified support (AEP and Powergen) and seven sought rejection of the Proposal.

Following close out of the consultation period Powergen confirmed the statement in its representation that it offered qualified support “*but only if modification proposal 563 “Delay to removal of NDM Forecast Deviation Tolerance” is also implemented*” as this would provide “*more time to enable our people and processes to be ready.*”

11.1 Inability of Users to advise Transco of their response to NDM demand forecast changes and the potential effect on efficient and economic operation of the system

SSE *“notes that the INS modification proposal (0479) was developed and implemented because it would encourage and incentivise shippers to provide Transco with a higher resolution of information about their projected end of day imbalance. SSE suggests that whilst some shippers might consider their own NDM demand forecasts to be more accurate than Transco's, and as a result, elect to deviate from Transco's NDM forecast, there is no mechanism available for shippers to inform Transco of that intention.” SSE “therefore fail to see how removing the INTQ will improve the economic and efficient operation of the system.” SSE further suggest that “Transco would find it very difficult to interpret the INS nominations if the INTQ were to be removed.”*

LE considers that *“the removal of the INTQ will penalise Shippers for following Transco's nominations and may, as a result, lead to a conflict between a balancing position and predicted balancing position. INTQ removal may hinder Transco by reducing Shippers' reliance on the NDM service, which will lead them to possible deviations from the Transco forecast. Transco will be unable to take more effective balancing action as the Shipper may mislead it through inaccuracy or deviation from the Transco forecast.”*

Shell comment that a User's inability to advise Transco that it intends to use its own forecasts of demand *“could lead to Transco using incomplete information in its balancing actions, undermining the efficient operation of the system.”*

TXU comment that the *“effect of this modification may be to incentivise Shippers not to track Transco's NDM nominations”*. It further *“believes that in the absence of a mechanism to notify Transco of the position might reduce the accuracy of the information available to Transco”*.

Transco's response:

Transco considers that the current energy balancing regime provides an incentive for Users to endeavour to achieve a daily balance but with relief from SMP cashout price exposure provided, under some circumstances, up to the extent of the inaccuracy associated with the final NDM nomination. INS provides, to an extent, a mechanism by which Users are able to notify Transco of their intent in regard to matching demand changes. Removal of INTQ would add further weight to this facility by strengthening the incentive for Users to provide their best estimate of their allocated imbalance position. This should afford Transco greater confidence in the robustness of INS nomination information. Removing INTQ could therefore be considered to provide more robust data about the extent of any system wide expected supply/demand differences. This should be expected to promote greater certainty in respect of system balancing requirements which may facilitate more efficient and economic operation of the system.

In response to the comments provided by LE, Shell and TXU regarding Users possibly being incentivised to deviate from *“Transco's NDM nominations”* and the effect of this on the *“accuracy of information available to Transco”*, Transco considers that the INS Proposal incentivises Users to provide Transco with their best projection of their closed out allocated imbalance position. Removal of the INTQ would increase exposure to Users for differences between nominated and actual

imbalances. If the removal of INTQ leads to a situation where a User is able to respond to the incentive by developing models which are able to provide a more accurate NDM demand forecast for its portfolio than that provided by Transco, then the User could provide a more accurate projected imbalance. Since a User's projected imbalance will be used to inform Transco's balancing action decision-making process, improvement in this area may therefore offer the potential to improve the balancing action decision making process. This would arise from the greater certainty in respect of the difference between aggregate input and aggregate offtake flows over the day. As the day progresses this should provide greater certainty in respect of the expected flow rates that will be seen on the system. This may assist operational certainty but the INS incentives might increase the prevalence of Users making late flow rate changes. Hence it is difficult to assess whether the removal of the INTQ would assist the economic and efficient operation of the system.

Transco notes User statements that the removal of the INTQ might reduce User reliance and tracking of NDM nominations. Should this be the outcome Transco notes that this might make it harder to interpret the INS information.

Transco understands Users' concerns over their inability to provide Transco with additional information regarding the User's own NDM demand forecast and the potential that this might represent a lost opportunity for operational decisions to be informed by such information. Therefore, Transco considers that the merits of such information provision should be considered by the 0567 Review Group.

11.2 Requests to postpone implementation

LE comments that *"Modification Proposal 0479 "Incentivised Nomination Scheme" was agreed with the concept of an "Incentivised Nomination Tolerance Quantity" (INTQ). As the modification has not even been implemented the industry has not had a chance to adjust themselves to producing imbalance forecasts. Also, removing INTQ now, before it has started might confuse the success/impact of INS."*

BP considers that the Relevant Objectives *"would be better served by gaining an understanding of the operation of the scheme in its agreed form [including INTQ] before considering any changes"*.

BGT *"seeks consistency in the timing"* with other Proposals particularly Modification Proposal 0563 *"Delay to the removal of NDM Forecast Deviation Tolerance"*.

SSE considers that the status of INTQ should be considered *"as part of the wider debate that will be facilitated through Review Group 0567"*. Shell echo this position.

Powergen offers qualified support for the Proposal but with the caveat that implementation is delayed in line with the dates proposed in Modification Proposal 0563, i.e. 1st October 2003, to provide more time to prepare for the change.

Transco's response:

A Modification Proposal should only be recommended for implementation if it is anticipated to further the relevant objectives. INS, as defined by Modification

Proposal 0479, has been implemented on this basis. Removal of the INTQ should only be recommended if it is expected to further the relevant objectives when compared with INS, as defined by Modification Proposal 0479, which includes the INTQ.

11.3 Effect of the Proposal on different classes of User

AEP believe "that it is inappropriate for users with NDM loads to benefit from a tolerance associated with inaccuracies in Transco's NDM forecasts". Also, "Shippers who have NDM loads within their portfolio can choose to rely on Transco's NDM forecasts when seeking to balance or to use their own forecasts. It is therefore appropriate, within the framework of INS, that shippers with NDM loads face the same incentives as shippers [with] DM loads. If the tolerance remained in place, it would discriminate unduly between different classes of shippers. This would not better facilitate the objective of facilitating competition between shippers and suppliers."

Transco's response:

INS encourages Users to inform Transco, prior to the next INS Forecast Daily Imbalance Time, of any changes to their intended end of day imbalance position. Retention of the INTQ would provide a degree of protection against nominated and actual imbalance differences that might be considered attributable to the variance between NDM nominations and allocations under some circumstances. It should be noted however, that any level of tolerance will, to an extent, reduce the incentive properties of the INS Proposal. However, variances between Users NDM nominations and attributed quantities will be a function of the variances between projected and actual demands in respect of both LDZs and DM loads. Thus the accuracy of NDM nominations is at least in part dependent on the accuracy of DM nominations. Therefore, Transco considers that the different treatment of NDM and DM load is not necessarily inappropriate.

Transco recognises that these complex issues have not been thoroughly explored in this consultation and hence it might be appropriate for the treatment of NDM load to be a subject of discussion in 0567 Review Group.

11.4 Inability of Users to respond to the increased risk generated by the removal of INTQ

Agip comments that "it is extremely unlikely that a User will be able to forecast their end of day position exactly and so they will always incur imbalance penalties and INS penalties if a tolerance is not in place. Providing Users with a tolerance will ensure efficiency in that it does not cost more to operate the scheme than the penalties generated by it."

Shell notes that "As NDM changes within the day are outside shippers control, this modification will only expose shippers to inappropriate risk."

Innogy states that "Although there may be an argument for increasing incentives on NDM shippers, these are only appropriate where NDM shippers are able to mitigate

their increased exposure. We do not believe that NDM shippers are currently in this position and would be exposed to a charge on an imbalance that they cannot effectively manage. We therefore believe that the INTQ protection for NDM should be retained."

SSE considers *"that irrespective of whether the NDM Forecast Deviation is removed [Modification Proposal 0511] or retained, removing the INTQ without providing shippers with the ability to manage the risks of variance between NDM nominations and allocations simply exposes NDM shippers to potentially penal costs which they cannot control."*

AEP note that it is *"appropriate, within the framework of INS, that shippers with NDM loads face to same incentives as shippers [with] DM loads."*

Transco's response:

Transco recognises User concerns regarding their ability to respond to and/or mitigate against the increased exposure to costs that would arise if INTQ was to be removed from the INS.

However, should this Proposal be implemented, Users will continue to have the facility to moderate their exposure to INS charges by revisions to INS nominations or by gas trading or by physical flow management where appropriate. Additionally those best able to predict NDM attributed demand will gain competitive advantage.

It should also be noted that all revenue from the INS charges will be considered as revenue to Balancing Neutrality. As such, those Users who are better able to respond to the incentive will obtain a competitive advantage.

11.5 Establishment of the tolerance quantity.

Agip does *"not believe that the methodology to establish the absolute level of tolerance should be linked to the NDM deviation as this unduly favours those with large NDM portfolios"* since different Users face different balancing risks each of which are as valid as any other. Instead it *"believes the most equitable way of apportioning tolerances to Users is on a fixed basis."* Agip proposes a fixed tolerance quantity *"in the region of 200,000 therms, or more."*

Transco's response:

Any level of arbitrarily determined fixed tolerance should be expected to undermine the incentive properties of the INS. This should therefore only be considered if the effect of a fixed tolerance can be shown to further the relevant objectives. These issues have been considered in previous Modification Proposals and such an approach has been rejected.

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

Implementation is not required to enable Transco to facilitate compliance with safety or other legislation.

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 Modification Proposal

If this proposal is implemented, the INTQ would be removed by changing a set-up parameter in the INS system.

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

No implementation timetable is necessary given the Transco recommendation in this report.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that this Proposal should not be implemented.

17. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This revised Modification Report contains Transco's proposal not to modify the Network Code but has been prepared following direction from the Gas & Electricity Markets Authority.

19. Text

SECTION E: DAILY QUANTITIES, IMBALANCE AND RECONCILIATION

Amend paragraph 5.3.8 (a) to read as follows:

(a) a User's "**Forecast Performance Measure**" at a Forecast Daily Imbalance Time in respect of a Day shall be calculated as follows:

$$FPM_t = abs (N_t - A)$$

where:

FPM_t is the Forecast Performance Measure at Forecast Daily Imbalance Time 't';

N_t is the User's Prevailing Forecast Daily Imbalance at Forecast Daily Imbalance Time 't';

A is the User's Daily Imbalance in respect of the Day; and

Delete paragraph 5.3.8 (c)

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

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 **0552**, version **2.0** dated **24/09/2002**) 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 **2.0**.

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.