# Modification Report
# Facilitation of Shrinkage Provider to make NBP Trade Disposals
# Modification Reference Number 0579
Version 1.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

## 1. The Modification Proposal

The restriction on making Disposing Trade Nominations should be relaxed to allow the Shrinkage Provider to make Disposing Trade Nominations up to a limit of the aggregate quantities associated with Acquiring Trade Nominations for the gas day.

## 2. Transco's Opinion

Transco has recently made changes in the way that it procures gas for the Shrinkage Provider's (SP) account. The financial benefits from this change will be shared with Users through operation of the SO incentive schemes specified in Transco's GT Licence.

The Network Code does not permit the SP to make NBP trade disposals. Given that the NBP is the focus of most prompt market trading activity, this restricts the ability of the SP to manage imbalance exposure. Transco's understanding of Special Condition 28B Part 2 14 (8) (g) of it's Gas Transporters Licence is that the revenues arising from the component of SP sales of gas will count as negative costs for the purpose of determination of the NTS SO gas cost performance measure. Therefore the prohibition on NBP trade disposals may increase costs for Transco and Users. Removing the restriction would better enable SP risk management activity and would overcome the currently perceived weakness that the SP Network Code rules encourage the SP account to be nominated "short" with prompt market procurement used to get close to balance, or very close to, during the gas flow period. Although unproven, Transco also notes the concerns expressed by some market participants that any such bias might also increase the risk of upward pressures on prompt prices with consequent impact on the forward curve.

The SP account is not liable for transportation charges. This has been a feature of the SP arrangements since the start of the Network Code and Transco believes this was known and taken into account by Ofgem in the setting of allowed revenue and incentive targets within Transco's price control arrangements. Therefore, to preserve the assumptions that underpin the SO incentives, Transco believes that it would be inappropriate for the SP to accept gas at the beach in excess of that required to balance the SP account but then subsequently sell any such excess gas at the NBP. To address this the legal text supporting this Proposal includes a restriction that the quantity of gas which is the subject of disposing NBP trades, must be less than, or equal to, the quantity associated with NBP trade acquisitions for that Gas Day.

During the development of this Proposal, it was suggested that Transco should be required to make additional information available in respect of the operation of the SP account where it is involved in NBP trade disposals in excess of a threshold. Transco has carefully considered the views of respondents before concluding that obligations to publish further information about procurement and disposal activity would be inappropriate.

Transco's view is that such reporting is unnecessary and would impose an inappropriate burden and risk on both Users and Transco. The SO incentives provide financial incentives on Transco which ensure that Transco and User interests are aligned. Obligations to provide reports to Users about specific trading activity is likely to reveal commercial strategies that would potentially act to the detriment of the efficient operation of the SP account. Transco is, however, obliged to report extensively to Ofgem about the SP procurement activity and the combination of Ofgem's monitoring of the activity and the extensive audit requirements defined in Transco's Licence are sufficient to ensure that Transco is not acting inappropriately in its role as SP. Any further wider release of information should be at the discretion of Transco in the light of commercial confidentiality considerations. Transco will consider requests for information that might be disclosed to the industry, perhaps via the Operational Forum or NT&T Workstream meetings.

Transco's view is that this Proposal has no impact in respect of interactions between the system operation of the gas and electricity regimes and Transco note that no respondents drew attention to potential interactions.

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

Implementation of the Proposal would remove an asymmetric feature of the arrangements that might be expected to generate under delivery of gas into the SP account, particularly in respect of ahead of day and early within-day nominations. Implementation of the Proposal would tend to reduce the costs of Shrinkage and encourage physical gas flows onto the System in respect of the SP account which are more closely aligned with underlying system design assumptions and efficient operation of the System. Therefore implementation could be expected to improve the economic and efficient operation of the System.

Additionally, implementation of the Proposal would enable Transco to manage financial exposures in the market place, thereby potentially providing extra liquidity and trading and a means by which any excess SP gas can be sold in the NBP market. This could be expected to promote greater market efficiency and therefore further promote competition between Users.

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

### a) implications for the operation of the System:

The removal of the restriction on disposing NBP trades is likely to remove an asymmetry that might be expected to diminish the likelihood of the under-procurement of gas against anticipated daily SP quantities. Implementation might therefore give rise to an improved physical balance on the System.

**b) development and capital cost and operating cost implications:**

Transco does not envisage any development or capital cost implications. Operating cost implications are viewed as marginal. Any such costs will be shared with Users in accordance with the relevant SO incentive scheme.

**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:**

Any such costs will be shared with Users in accordance with the relevant SO Incentive scheme. To the extent that shrinkage costs were reduced as a result of implementing this Proposal, the benefits would be shared with Users in accordance with the SO Incentive scheme parameters.

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

Transco does not believe that implementation of this Proposal would have any effect on 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**

This Proposal affords Transco an opportunity to better manage the contractual risk to Transco under the SP terms.

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

No development issues are envisaged.

**7. The implications of implementing the Modification Proposal for Users**

Users would be able to purchase NBP gas from Transco thereby potentially increasing the liquidity of the gas market.

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

No direct 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**

Transco is not aware of any impact on legislative and regulatory obligations.

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

**Advantages:**

- may reduce shrinkage costs (to the immediate benefit of both Transco and Users);
- may improve supply/demand balancing by encouraging the Shrinkage Provider account to have procured gas close to end of day requirements early in the day; and
- provides an opportunity to further enhance NBP liquidity.

**Disadvantages:**

- Transco has not identified any disadvantages.

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

Seven responses were received to the consultation:

| Respondent | Response |
|---|---|
| EnMo | Support |
| AEP Energy Services Ltd (AEP) | Qualified Support |
| London Electricity Group (LE) | Qualified Support |
| Entergy-Koch Trading Europe Ltd (EKT) | Against |
| Statoil (UK) Gas Limited (STUK) | Against |
| Shell Gas Direct Ltd (SGD) | Against |
| British Gas Trading Ltd (BGT). | Against |

However, BGT did accept that the Shrinkage Provider should be able to make limited NBP trade disposals.

**Current Asymmetry in the Shrinkage Provider Procurement Arrangements**

Representations

AEP and BGT noted the asymmetric risk for the Shrinkage Provider inherent within the Network Code.

Transco view

It is this asymmetric risk that justifies implementation of the Proposal. Transco believes that the current asymmetry might encourage under-nomination of gas into the Shrinkage Provider account until later than might be considered consistent with the economic and efficient operation of the System.

**Speculative Trading**

Representations

BGT and EKT commented about speculative trading. Whilst BGT noted that "Transco's Licence limits the extent to which they can undertake speculative trading" it did not support a "Code change which (albeit in isolation) would be consistent with unlimited trading".

Transco view

Transco is prohibited from speculative trading by Special Condition 26: Prohibited Procurement Activities, and behaves accordingly This Condition limits trading activities for the purpose of facilitating balancing management and constraint management so long as such transactions are conducted on economic and efficient terms and facilitate the economic and efficient operation of the transportation system.

**NBP Purchase and Sale Quantities**

Representations

BGT noted that "there is no limit on the quantity of gas that the Shrinkage Provider can procure at the NBP, and this Modification does not propose any limit". Additionally, BGT "does not believe that Transco should be prevented from selling at the NBP when they have over-estimated their requirements, but we believe there should be some restriction on Transco's trading activities".

LE suggested that "a cap should be placed on the amount the Shrinkage Provider is allowed to dispose of".

Transco view

Transco agrees with BGT that this Proposal does not seek to limit the quantity of gas that the SP can procure at the NBP. However, within the Proposal, a limitation has been included in respect of the extent to which Transco, acting as Shrinkage Provider, can dispose of gas at the NBP. Such disposals are limited to a quantity no greater than the quantities purchased at the NBP in respect of such Gas Day.

**Shrinkage Provider Commercial Framework**

Representations

AEP did not agree with some of the statements made by Transco in the Draft Modification Report 0579. The AEP representation stated "AEP believe that is (sic) was clear that in setting the SO incentives, Ofgem did not assume that the Shrinkage Provider would avoid transportation charges."

Transco view

The current treatment of transportation charges in respect of the Shrinkage Provider account is a feature of the initial Network Code design and implementation, constituting one of the enduring features of the Network Code. Transco notes that the

SO incentive proposals included no reference to changes in the treatment of transportation charges in respect of the Shrinkage Provider account.

**Transco Access to Markets**

Representations

EnMo noted Transco's concern “over the type and timing of any information which it publishes to the community regarding its trading activity as Shrinkage Provider”.

EnMo advocated “that any such activity is confined to that of a regulated, cleared and anonymous trading system”. EnMo also noted “the potential for misunderstanding in that many observers will believe that ‘Transco are in the market, confusing this with the Balancing role”.

STUK suggested that the Proposal “could have a distortional affect on the traded gas market” and that “continuing to prohibit disposing trade nominations should provide an incentive on Transco as shrinkage provide(sic) to increase the accuracy of their forecasts and therefore lower the costs to both themselves and shippers”.

SGD noted that Transco had "recently made changes to the a way (sic) that it procures gas for the Shrinkage Provider account but no information has been available to shippers to be able to judge the effects of these changes”. Additionally, SGD commented that it remained "unconvinced that it is the role of the monopoly system operator to increase liquidity”.

Transco view

Transco would wish to make use of a regulated, cleared and anonymous trading system whenever it considers such usage to be economic and efficient. Specifically, Transco believes that, under many circumstances, the OCM might be used to facilitate risk management of the SP account. The legal drafting associated with this Proposal allows the SP to make Market Offers thereby facilitating OCM access.

Currently the OCM is the only market mechanism being used by Transco for the purposes of Market Balancing Actions. Therefore, there is no scope for the confusion identified in the EnMo response.

Transco does not consider that allowing the SP to make NBP trade disposals is likely to distort the traded market. Transco believes that the current asymmetry is likely to leave the SP account short generating extra demand late in the day. Whilst unproven, Transco notes the concerns expressed by some market participants that any such bias might also increase the risk of upward pressures on prompt prices with consequent impact on the forward curve.

Transco notes that STUK considers the prohibition on disposing trade nominations should provide an incentive on Transco to increase the accuracy of their shrinkage forecasts. If this is the case, Transco would anticipate that a similar prohibition on User disposing trade nominations would increase the accuracy of User demand forecasts. If STUK wish to pursue this matter, it may wish to raise this for consideration at the NT&T Workstream.

Transco considers that it should have discretion in respect of the information that it releases in respect of the SP procurement process. Transco does not expect to have any obligations that do not apply to any other market player. It is important to recognise that shrinkage requirements are approximately 2% of system throughput and therefore there are many Users that have larger throughputs and larger prompt balancing requirements than those associated with the SP.

Transco notes the comments about the monopoly system operator and liquidity of the gas market. The Proposal is designed to increase the efficiency of the SP risk management processes. The SO role is therefore aligned with promotion of liquidity in a manner that is consistent with economic and efficient operation of the System.

**Shrinkage Provider Information Provision**

Representations

BGT indicated that Transco “should be obliged to report to Users the full circumstances (quantities, NDM forecasts, other relevant background etc) for every day when their Disposing Trade Nominations exceeds a set threshold, say 2% or more of the day’s Shrinkage Quantity”.

AEP stated “there should be sufficient transparency to enable shippers to monitor Transco’s conduct”.

SGD “are disappointed that Transco has made no specific proposal” in respect of reporting arrangements.

Transco view

Transco would point out that the Licence creates both incentives and obligations for Transco and that it would expect Ofgem to monitor Transco’s conduct. Indeed, Transco notes the extensive reporting required under the Licence in respect of the Shrinkage Provider account, which is the subject of an audit defined by Special Condition 33 to confirm Transco performance in respect of Special Condition 28B.

The SO incentive structures and the obligations defined by the Licence have been designed to encourage efficient behaviours. The Community should be confident that under most circumstances, the alignment of Community and Transco interests should deliver appropriate behaviours. Transco has consistently argued that information release should not prejudice Transco’s commercial activity. Thus, Transco does not consider that it would be appropriate to have obligations to provide information either under the circumstances specified by BGT or in the form identified by AEP, that do not apply to all market participants. Transco considers that it should have discretion over the extent of information release in a similar manner to all other market participants. Where Transco considers that a release would benefit economic and efficient operations then it would anticipate such release.

Transco believes that information exchange needs to be carefully considered and welcomes the recent publication of the DTI response to the November 2001 document: "Gas: a consultation on concerns about gas prices and possible improvements to market efficiency" (URN 02/1306). The DTI advocated the development of criteria to inform decisions about information release. Transco will shortly be increasing the extent of information release as part of the first stage of Phase III of the Information Exchange programme and anticipates discussions about further information exchange as part of forthcoming NT&T Workstream discussions.

**Interactions with Other Incentives**

Representations

EKT noted the opportunity to arbitrage existing incentive arrangements. BGT noted that "Transco would also have the scope for using line-pack to 'move' trades from one day to the next, buying low-price days and selling on high-price days".

Transco view

The SO incentive structures have been developed to promote greater efficiency of Transco's operational and commercial activity. The structure of these incentives may generate trade-offs in respect of performance between the various schemes. Experience, in the light of other obligations and specifically the obligation in respect of efficient, economic and co-ordinated operation of the system, will indicate the trade-offs and consequential behavioural outcomes that will inform subsequent SO incentive development. Where these indicate a change in incentive structure might be appropriate, this should be addressed in a licence modification consultation.

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

Implementation of the Modification is not required 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**

Implementation is not proposed as a result of changes to the methodology established under Standard Condition 4(5).

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

Transco would be required to modify its internal procedures to facilitate disposing NBP trades.

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

Transco proposes implementation of this Proposal as soon as possible.

## 16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends that this Proposal is 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 Modification Report contains Transco's proposal to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

## 19. Text

**<u>Section N</u>**

Amend paragraph 4.2.2 to read:-

"4.2.2 The Shrinkage Provider:

(a) . . . . . . ;

(b) . . . . . . ;

(c) . . . . . . ;

(d) may make Acquiring Trade Nominations and Disposing Trade Nominations in accordance with Section C6: provided always that the Shrinkage Provider may only make a Disposing Trade Nomination in respect of a Gas Day where the aggregate Trade Nomination Quantity of all Disposing Trade Nominations made by the Shrinkage Provider in respect of such Gas Day is less than or equal to the aggregate Trade Nomination Quantity of all Acquiring Trade Nominations made by the Shrinkage Provider in respect of the same Gas Day;

(e) . . . . . . ;

(f) may post Market Offers;

(g) . . . . . .;

(h) . . . . . .."

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 **0579**, version **1.0** dated **25/11/2002**) 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 **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.