



Shippers, Transco and Other Interested
Parties

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value to customers*

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Dear Colleague,

Network Code Modification Proposal 0553 – ‘Amendment of imbalance calculations to enable elective aggregation of demand across one or more shipper IDs ’

Ofgem has carefully considered the issues raised in network code modification proposal 0553 *‘Amendment of imbalance calculations to enable elective aggregation of demand across one or more shipper IDs’*.

Ofgem has decided to direct Transco not to implement the modification because we believe that it will not better facilitate the relevant objectives of Transco’s network code as outlined in standard condition 9 of Transco’s Gas Transporter (GT) licence.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background

The gas balancing regime provides shippers with incentives to balance their demand and supply over the gas day through the 'cash out mechanism'. These incentives are intended to target the costs associated with any imbalances back to those shippers that have caused them. Under this regime, shippers' inputs to and offtakes from the system are metered or allocated each day. Shippers face different cash-out prices depending on whether they end the day long on gas (their inputs exceed their offtakes) or short on gas (their offtakes exceed their inputs).

Shippers who are long (short) gas are cashed out at the lowest (highest) prices at which Transco has sold (bought) gas on the on the day commodity market (OCM) excluding trades made by Transco for locational gas. In the event that Transco has not taken any balancing actions cash out prices are determined using fixed differentials that are added to the weighted average price of gas traded on the OCM. The fixed differentials were calculated to be based on the costs of storage.

In electricity, under the rules of the Balancing and Settlement Code (BSC) all trading parties have their imbalance volumes determined by calculating the difference between their notified contracted volume for their energy accounts and their metered volumes. The BSC requires all trading parties to have separate consumption and production energy accounts and for all their Balancing Mechanism Units (BMUs) to have either a consumption or production status. Energy imbalance volumes are calculated separately for a trading party's consumption and production energy accounts and they cannot be netted off against each other. However, a trading party can net off imbalances caused by one of its consumption BMUs with another of its consumption BMUs within its consumption account and likewise for production BMUs.

Electricity trading parties have grid code obligations to provide NGC with a final physical notification (FPN) for each of its BM units at gate closure. The FPN sets out expected metered generation and demand volume for each BM unit for each half hour. Deviations between a BM unit's expected metered volume and actual metered volume could place the licensee in breach of its licence.

In the electricity arrangements, trading parties are also able to enter into an agreement with a third party (the consolidator) to allocate a fixed volume or percentage of their metered volume to the energy account of the other party. This effectively passes on the imbalance risk to the other party. This facility is known as a metered volume reallocation notification (MVRN) and the reallocation must be

between the same type of account, ie production to production or consumption to consumption.

Removal of NDM forecast deviation tolerance

In May 2002 Ofgem directed Transco to implement network code modification 0511 '*Removal of the NDM forecast deviation from imbalance calculations*' with effect from 1 October 2002. The NDM forecast deviation tolerance was originally intended to mitigate shippers' imbalance risk arising from errors in Transco's demand forecasting for NDM supply points by cashing out certain imbalance volumes at the system average price (SAP) rather than the relevant system marginal price (SMP). Ofgem believed that removal of this tolerance would strengthen incentives on shippers to balance at the end of the gas day and encourage them to take responsibility for their own demand forecasting by investing in internal resources or by acquiring forecasting services from external providers.

The proposal

Network code modification proposal 0553 proposes that shippers with more than one shipper ID should be allowed to aggregate their demand allocation. The lead shipper would then be responsible for balancing the inputs and offtakes for all the shippers within its group. It is proposed that initially a shipper within the group would reallocate 100% of their demand to the lead shipper but that the system could be refined to allow less than 100% re-allocation.

Under the proposal the energy balance of the shipper whose demand is being reallocated would be zero, whereas the shipper to whom demand was being reallocated would have an imbalance that reflected the difference between their total inputs and their own demand plus that which has been reallocated to them. It is intended that through the aggregation of shipper allocations it may be possible for shippers to reduce their imbalance charges through the netting off of individual imbalances across the shipper group.

Respondents' views

There were three representations to this modification proposal. Two respondents supported the modification proposal and one respondent gave qualified support.

The respondents noted that the modification would introduce the equivalent of MVRNs in electricity and supported the alignment with the wholesale electricity market. According to a respondent, mergers and acquisitions in the gas industry have resulted in many shippers operating a number of different shipper licences. In the short term, these shippers may not be able to aggregate all their licences and in the long term they may have strategic reasons to keep them separate. This respondent noted that the number of shippers that operate with two or more shipper accounts may increase in the future. Another respondent argued that there would not be a limited take up of the re-allocation service since shippers with multiple portfolios ship a significant volume of gas through the system.

One respondent noted that it is harder to accurately forecast demand over multiple shipper IDs and that this problem is compounded by the introduction of network code modification 0511 where failure to accurately forecast will trigger a penal cash out charge. The respondent stated that the proposal would help the industry with forecasting, balancing and risk management. Another respondent commented that aggregation would help shippers to better manage their imbalance exposure and that the ability to reallocate demand would serve to reduce the risks of marginal imbalance cash out for shippers and therefore potentially enhance shippers' ability to manage their portfolios more economically and efficiently. It also believed that it would give Transco better information about shipper intentions, which would help it perform its role as residual gas balancer more efficiently. The respondent claimed that competition in shipping could be further stimulated if new entrants could contract with another shipper to manage their imbalance risk.

This respondent also disagreed with Transco's view in the draft modification report that the costs of the proposal outweigh the benefits. It argued that some elements of the service are already facilitated for parties who outsource gas operational cover and as such the costs should not be so significant. The respondent also stated that the costs of implementation should not be targeted to those shippers that take up the service.

The respondent offering qualified support stated that although it supported the principle underlying the proposal, it believed that Transco's cost assessment of £1.5 to £2 million for implementation via AT Link was unreasonable. It therefore suggested incorporating the modification through the development of Gemini if the costs make it reasonable to do so.

A respondent noted Transco's concern that the Incentivised Nomination Scheme (INS) would need to be amended if the modification were to be approved, as INS requires shippers to provide nominations, for each shipper account, of their intended end of day imbalance. It then suggested that individual shippers within the group would not be responsible for their INS nominations but rather this would be the role of the lead shipper.

This same respondent also commented on a number of credit issues raised by Transco with respect to the proposal. The respondent stated that Transco's calculations of indebtedness would not be altered as a result of the proposal and that Transco would be monitoring fewer credit positions than it does currently. Respondents also discussed potential issues problems with the implementation of this modification proposal, including necessary amendments to the invoice system, and the feasibility of sharing of confidential information.

Transco's view

Transco does not support the implementation of the modification proposal. It believed that the costs of implementation would significantly outweigh the benefits and argued that the investment to implement the modification is unlikely to be economic or efficient. Transco maintained that the proposed changes in the modification proposal would require significant systems changes. In particular, it stated that the proposal would affect the allocations and balancing processes and could affect the nominations and demand attribution processes. Transco stated that the implementation of changes to AT-Link would represent a risk to the overall stability of the systems. Transco suggested that a change to the daily allocation processes as described in the modification proposal could only be implemented as part of Project Gemini for Autumn 2003.

Transco argued that the funding to implement the modification might be regarded as cross subsidising those shippers who took advantage of the service. In particular, Transco claimed that only a small number of shippers operate with two or more accounts and would therefore benefit from the additional management tool. In this respect, it suggested that it could consider addressing the potential cross-subsidy by introducing cost reflective charging arrangements.

Transco stated that shippers have a choice about how they organise their businesses based on the costs they face. Thus, it suggested that shippers could aggregate their

portfolios into a single account to achieve the benefits of aggregation where it is cost effective to do so.

Transco also states that the benefits from the proposal are likely to be marginal. In this respect, Transco states that any reduction in imbalance exposure resulting from the netting off of imbalances would not be significant since uncertainty with NDM demand is likely to be well correlated across the portfolios. Transco indicated that it had carried out analysis which suggested that any improvement in the cash-out exposure from the proposal as a result of the aggregation of imbalances of a typical NDM group shipper would equate to a reduction in revenues into energy neutrality of £50k per annum.

In response to shipper views about consistency with the wholesale electricity market, Transco maintained that there were fundamental differences between the two regimes. In gas, participants have a single energy balancing account which nets off supply and demand whilst, in electricity, participants have to separately balance two accounts, production and consumption. Furthermore, Transco stated that in electricity metered volumes can only be reallocated from production to production or supply to supply and that the MVRN process takes place at the BM unit level with metered volumes being reallocated at this level. Transco stated that its logical NDM meter points are at a shipper level and that to adopt the MVRN model would require a new accounting point and significant systems and business process changes. Transco also noted that the requirements for it to provide demand forecasts in gas are much greater than the requirements on NGC for electricity.

Transco noted that the modification proposal would necessitate changes to shipper credit rules, an assessment of the impact on billing systems in the instance of aggregation of shipper invoices, and changes in a number of other network code sections, including those relating to protected information and INS. It would also require further consideration of confidentiality issues.

In terms of credit issues Transco agreed that the nominated lead shipper could address the credit issues associated with other shippers in the group structure. However it considered there would still need to be changes proposed to the Energy Balancing Credit Rules and the network code to take account of credit issues (eg to recognise the lead shipper relationship). Transco disagreed with respondents on the issue of exposure monitoring and commented that monitoring may in fact increase with monitoring being required at an individual and aggregated level.

Further information obtained from Transco

After receiving the final modification report, Ofgem requested additional information from Transco about the potential timescales and costs for implementing the proposal within AT Link and Project Gemini. Transco confirmed its view that implementation of the modification via AT Link would not be feasible.

Therefore, Transco suggested a possible implementation date of December 2003 through the new Gemini system and it estimated implementation costs with Gemini to be in the range of £360,000 and £600,000.

Ofgem also requested that Transco address one respondent's assertion that some elements of the service proposed are already being facilitated for parties who out source operational cover. Transco responded that IT systems are present that provide shippers with the option to appoint a third party agent to undertake out of hours operational cover. However, Transco stated that the implementation of the modification proposal would still require substantial systems changes to introduce new functionality and that these changes would relate to the setting up of new lead and subsidiary user relationships and the re-apportionment of demand allocations.

Ofgem's view

Ofgem has carefully considered the issues raised as part of modification proposal 0553 and whether the proposal better facilitates the achievement of the relevant objectives of Transco's network code.

Ofgem agrees that implementation of modification 0553 could provide shippers with an additional risk management tool with which to manage their gas portfolios. Furthermore, we agree that imbalances could be reduced by netting off individual imbalances across a shipper group.

However, Ofgem also recognises that shippers have a strategic choice about whether to maintain one or multiple shipper IDs and that shippers with multiple IDs can achieve similar benefits by consolidating their portfolios internally.

Further, Ofgem considers that there are significant costs involved in the implementation of this proposal especially when compared to the potential benefits

that may accrue to the limited number of shippers that are currently holding two or more shipper IDs. A less costly option would be for shippers with multiple shipper IDs to incorporate their portfolio into one account through the change of supplier process (CoS). Although the industry has expressed concerns about the costs involved in undertaking this process, it is worth noting that the industry is currently working towards a resolution of these issues.

With this in mind, we are not convinced that the implementation of the proposal would better facilitate the relevant objective of the efficient operation of Transco's system as outlined in standard condition 9 of the Transco GT licence.

Ofgem notes that respondents have indicated that the proposal would align the gas arrangements with those that apply in electricity. Whilst there are some parallels with the electricity arrangements Ofgem considers that there are also relevant differences between the two sectors. For example, in contrast to the electricity sector, gas shippers are able to trade to manage their imbalance positions within day whereas electricity participants cannot trade to adjust their balance positions within the electricity balancing period. Further, in the gas sector shippers are able to engage in after the day trading in gas to manage their imbalances. This is not the case in the electricity sector. Given the ability of shippers to manage within day imbalance positions and to trade after the gas day, Ofgem considers that the benefits associated with this proposal in terms of managing imbalance risk are not as significant as they may be in the electricity sector. As such, Ofgem is not at this point convinced that there is sufficient justification for Transco to incur the significant costs associated with the implementation of this proposal.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct Transco to implement network code modification proposal 0553 as we do not believe that it better facilitates the achievement of the relevant objectives as outlined under standard condition 9 of Transco's GT licence.

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, appearing to read 'M Feather', is positioned in the upper left area of the page.

Mark Feather
Head of Gas Trading Arrangements