

Modification Report
Delay to removal of NDM Demand Forecast Deviation Tolerance
Modification Reference Number 0563
Version 1.0

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

The proposer identified the nature of the Proposal as:

"To delay implementation of Modification Proposal 0511 until 1 October 2003.

This delay will enable a Network Code Review Group to be convened to investigate:

- whether the Demand Attribution process might be improved;
- what information might be released by Transco to better facilitate individual User NDM demand forecasting;
- how information from Users might be provided to Transco;
- how information from Users might be used by Transco;
- what further risk mitigation might be appropriate either within or outside of the Network Code to facilitate efficient risk management for Users whilst facilitating the economic and efficient operation of the system;
- whether it is appropriate for Users with NDM portfolios to be fully exposed to the risk of SMP cashout; and
- whether some form of error correction mechanism to address demand attribution processes before, during and after the day might be appropriate."

2. Transco's Opinion

Transco notes that the primary reason for the Proposal is to provide Users with more time to prepare for the implementation of Modification Proposal 0511.

In the Modification Proposal 0511 decision letter Ofgem recognised that Users may need time to prepare for the implementation of the Modification Proposal 0511. In choosing to direct implementation from 1st October 2002 Ofgem stated that, *"This date takes account of the time shippers have had since the Modification was proposed in December 2001 to consider the effects of its possible implementation."*

Users may desire better forecasting services and/or risk mitigation tools to manage the increased risks arising from implementation of Modification Proposal 0511. Users claim not to be adequately prepared for implementation. Users have also cited confusion over the effect of Modification 0496 "Improvements to NDM Demand Attribution" as a contributory factor. Generally, Transco would not recommend delay for such reasons. However, in

regard to this Proposal, Transco believes there are additional reasons why a delay might be appropriate.

Recent workstream discussions have indicated that implementation of the Proposal might generate operational issues for Transco since Users may face weaker incentives to track NDM demand nominations but greater incentives to balance actual supply and demand. This could have detrimental implications for operational balancing efficiency.

Transco is also mindful that Modification Proposal 0479 "Incentivised Nomination Scheme" will be introduced on 1 October 2002 which is intended to enhance the system balancing action decision making process. Implementing removal of NDM Forecast Deviation at a later date may therefore better enable an assessment of the efficacy of each regime change.

Transco believes there may be merit in considering a delayed implementation date for Modification Proposal 0511, that would allow individual Users time to assess the opportunity to utilise demand information recently provided to Users by Transco which might improve User NDM demand risk management capabilities. Moreover, such delay might enable the 0567 Review Group to consider a range of issues that may assist regime operation when Modification Proposal 0511 is implemented. These could include means by which Users advise Transco of their NDM demand forecasts, and the manner in which Transco would be able to use such information to influence its balancing action decisions and whether additional NDM Demand Attribution runs might be helpful. Transco therefore recommends that this Proposal is implemented.

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

Implementation of the Proposal would prevent Users from being fully exposed to SMP based cashout on their entire imbalance. This would provide incentives to Users to balance against the final NDM nomination which could be expected to give benefits in respect of the economic and efficient operation of the system. Additionally it would permit time for Users to develop better approaches to manage their risk exposure. Removal of the NDM Forecast Deviation before Users have been able to develop appropriate risk management strategies might be considered to jeopardise competition between Users.

Additionally very late User responses to achieve close to a balance position may generate late flow rate changes on the system generating increased linepack variation late in the day perhaps after Transco had already taken corrective balancing actions. Implementing this Proposal may also therefore act to promote economic and efficient operation of the system.

4. The implications for Transco of implementing the Modification Proposal , including a) implications for the operation of the System:

By providing relief in respect of SAP rather than SMP cashout on part of a Users' imbalance implementation, may provide stronger incentives for Users to use the final NDM

nomination as the best estimate of NDM attributed demand to be used for imbalance calculations. This will encourage Users in aggregate to balance against the aggregate demand projection made during the gas day which may better facilitate economic and efficient system operation.

b) development and capital cost and operating cost implications:

Transco does not consider there to be any implications in this area.

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:

Transco does not consider there to be any implications in this area.

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

Transco does not consider there to be any implications in this area.

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

Transco does not consider there to be any implications in this area.

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

As the Proposal seeks to delay the implementation of Modification Proposal 0511 the effects on Transco's system developments are minimal. The Proposal may assist Users in the development of their systems to support the introduction of Modification Proposal 0511 by allowing them additional time to develop appropriate forecasting tools.

7. The implications of implementing the Modification Proposal for Users

By delaying implementation of Modification Proposal 0511, this Proposal would allow Users additional time to respond to the revised incentives. The delay will enable Users to acquire the additional information which might be needed to develop improved demand forecasting and to build, develop and/or purchase new or additional risk management tools.

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

Transco does not consider there to be any implications in this area.

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 does not consider there to be any implications in this area.

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

Advantages:

The Proposal maintains the incentive properties of Modification Proposal 0511 whilst allowing additional time for Users to respond to the revised incentive by developing risk management and forecasting tools, thus temporarily protecting Users from exposure to risks to which, in the short term, they may be unable to respond.

The Proposal may provide time for the industry to establish and commence a review of the NDM forecasting and attribution process before Modification Proposal 0511 is implemented.

The Proposal would also allow time for the industry to assess the impact of Modification Proposal 0496 "Improvements to NDM Demand Attribution."

Disadvantages:

The Proposal will delay the introduction of Modification Proposal 0511 which, in itself, increases Users' incentive to balance. As such any reduction in overall system imbalance, that may have been expected to have been generated by this increased marginal priced cashout exposure, will not be realised for a further 12 months. This may lead to Transco taking additional system balancing actions over and above those necessary if 0511 was implemented on 1st October 2002.

This Proposal delays the removal of an imbalance tolerance quantity. In its decision letter for Modification Proposal 0511 Ofgem stated that this "*deviation tolerance may create a cross-subsidy from DM to NDM customers*".

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)

Scottish Power UK Plc (Scottish Power)

11.1 Support or reject the Proposal.

BGT and AEP do not support the Proposal. BGT stated that *"The arguments in favour, and against, the removal of the NDM Forecast Deviation have been presented and considered as part of the consultation on Modification 511. In May 2002, Ofgem decided to direct Transco to implement the Modification with effect from 1 October 2002.....we do not consider that there are any pertinent factors evident at this time, which were not available at the time of Ofgem's decision in May. Consequently, we believe that this modification should be rejected on the basis of the rationale for implementation of Modification 511."*

All other respondents supported the Proposal. LE stated that it *"fully supports implementation of this modification so that the industry and Transco can have time to fully understand and mitigate the extra exposures and risks that we now face with the implementation of modification 511."* Shell stated that *"This modification will further the Relevant Objectives by ensuring that shippers can continue to be incentivised to follow Transco's NDM forecasts avoiding ill-informed balancing decisions thereby promoting efficient and economic operation of the system. It will further ensure that shippers are not faced with unmanageable risk and will therefore promote effective competition between shippers."*

Transco's response:

Workstream discussions since the decision on Modification Proposal 0511 have indicated that implementation of 0511 might generate operational issues for Transco arising from change to User balancing incentives. These may increase the uncertainty faced by Transco when assessing operational balancing requirements.

Transco does not believe that the current regime necessarily promotes Users to track NDM demand. However, Transco does believe that Users currently have incentives to manage their imbalance positions using the final NDM nomination as their best estimate of attributed NDM demand. This would not be the case if this Proposal is implemented. As such Transco considers that there may be merit in delaying the implementation of 0511 for a sufficient period to allow:

Users to assess the demand related information released by Transco and develop and implement suitable risk mitigation tools, and,
the 0567 Review Group to assess a range of issues that may assist regime operation.

11.2 Access to demand data.

Shell consider that if *"shippers are expected to be forecasting our own NDM demand, there will need to be the transfer of, and on-going access to a wide range of data."*

SSE echo Shell's point and also suggests that *"Shippers need to be on a level playing field in terms of information about their NDM demand so that they can properly manage the risk of SMP cashout in the absence of the NDM forecast deviation tolerance. Whilst we acknowledge that Transco has provided some of this information in recent weeks, there is insufficient time ahead of October 2002 for players to develop and test their forecasting/risk management models."*

LE states that *"Transco have been very forthcoming with the data and produced a proportion of the data requested."*

Scottish Power state that *"There is certainly no level playing field when it comes to NDM demand forecasting, in terms of internal resources and the availability of historical information on which to base any forecast. There are Users who enjoy considerable advantages because of their historical reliance on their internal demand forecasting techniques and information."*

Transco's response:

Transco is currently unaware of any data requested by Users to improve their NDM risk management that has not been supplied.

Transco considers that this Proposal should be implemented but that some of the issues raised by this Proposal can be considered in the wider context of how NDM load should best be treated in the energy balancing regime.

11.3 Delay required to allow Users to mitigate increased risk, develop systems and complete the 0567 Review.

SSE considers that *"Significant elements of Transco's demand forecasting/allocation methodology remain outside shippers' control. Shippers therefore require sufficient time to develop and improve their own forecasts or their assessment of the accuracy of the forecasts generated by Transco before they are exposed to SMP cashout risk".* BP, LE, TXU, Powergen, Innogy, and Shell echo this concern.

BP, Innogy, Shell and Scottish Power believe that it would be inappropriate to change the operation of the regime until Review Proposal 0567 has been given due consideration.

TXU and Innogy refer to Ofgem's Modification Proposal 0511 decision letter regarding the implementation timescales. Innogy state that *"We disagree with Ofgem's view that their proposed implementation date addressed User's concerns about adequate timescales and do not believe that prudent shippers would invest heavily in systems development in anticipation of implementation of a modification proposal."* TXU consider that *"in most cases lead times should be assumed to start from the decision date rather than the modification proposal date."*

Whilst BGT supports the 0567 Review, it is concerned that *"a 12 month delay to the implementation of Modification 511 to facilitate this review may result in a protracted process which may take considerably longer. We are of the opinion that a review of the NDM Forecasting process can be carried out without delaying the implementation of Modification 511. Indeed, we would comment that the review may be more focussed in achieving its objective if it is carried out under a balancing regime without the "comfort" of a Forecast Deviation Tolerance."*

AEP also considers that *"shippers have had sufficient time to prepare"* for the introduction of Modification Proposal 0511.

Transco's response:

In the final Modification Report for Modification Proposal 0511, Transco advocated the implementation programme should allow Users sufficient preparation time. Transco notes the majority view of Users that it will take time to develop appropriate systems and processes to manage risks in a cash-out regime without the NDM Forecast Deviation. Transco therefore still considers that given the decision that Modification Proposal 0511 should be implemented, a limited delay is appropriate as this will provide Users with a period of time within which they can respond to the regime changes. Transco believes that the 0567 Review process should not be a protracted process that should be allowed to delay implementation of Modification Proposal 0511 unless the 0567 Review Group can establish better ways of treating NDM demand.

Transco will support and participate in the 0567 Review Group.

11.4 Potential adverse effect on efficient and economic operation of the system.

SSE notes that Users are *"currently unable to inform Transco via their AT Link Output Nominations that they have decided not to track Transco's demand forecasts Transco will therefore be unaware if a shipper decides to deviate from Transco's NDM Output Nomination, which means that Transco could be unable to operate its system efficiently and economically."* *"SSE is concerned that Transco could be forced into taking inefficient and unnecessary balancing actions."*

LE also considers that if this Proposal is rejected *"Transco's balancing costs will increase because of Transco taking more balancing actions to correct the unknown position of Shippers NDM demand, the nominations for which Transco no longer will have the knowledge of."*

AEP does not believe that rejection of this proposal will generate operational issues, stating that *"Shippers will have an incentive through cash out to avoid any imbalance exposure. Whether they are relying on Transco's or their own forecast, shippers should trade to try and achieve a balance. Shippers should continue to nominate based on the best available information of their intended flows."*

Transco's response:

Transco considers that implementation of the Proposal may assist it to maintain economic and efficient system operation. Transco notes the view held by some that stronger incentives to balance might promote more efficient Transco balancing decisions. However this may not be the case in respect of balancing against NDM demand. The balancing decision making process depends on the assessment of the difference between the forecasts of inputs and outputs. Transco forecasts of offtakes from the NTS take account of aggregate LDZ level demand projections. These forecasts take account of large DM nomination information provided by Users and, where appropriate, end users. Transco takes balancing actions and manages flows across the NTS/LDZ interface based upon these forecasts.

It is possible that balancing efficiencies might be improved if Transco was to have information about the individual User forecasts of NDM demand and Transco was able to use such information to generate more accurate forecasts to inform system operation and the system balancing decision making process.

However, implementation of Modification Proposal 0511 will not provide such information to shippers and hence Transco believes that implementation of a delay is appropriate. The 0567 Review Group should carefully consider whether such information provision might be appropriate.

11.5 Effective competition between Users.

AEP considers that *"If the removal of the tolerance was delayed, it would discriminate unduly between different classes of shippers."* Also, that the current tolerance *"leads to a cross-subsidy between shippers with NDM loads in their portfolio and those without NDM loads through the neutrality and cash-out mechanisms."*

Shell believes that this Proposal will *"promote effective competition between shippers"* by ensuring that *"shippers are not faced with unmanageable risk"*.

SSE reasons that *"Removing the demand forecast error protection with no amendment to the prevailing penal cashout regime will inevitably lead to a cross-subsidy from NDM to DM shippers."*

Transco's response:

Transco does not accept that the current regime unduly discriminates between different classes of shippers. Subject to undue discrimination considerations, the Network Code has been designed to promote competition between Users and facilitate economic and efficient operation. The NDM Forecast Deviation was structured to avoid the uncertainty of many Users chasing very uncertain demand late in the day. The uncertainty arising from such an approach might generate increased flow rate variations on the system late in the day and create risk of increased system balancing costs that would be recovered from all Users with apportionment proportional to physical flows. The NDM Forecast Deviation may therefore

both assist to keep costs down for DM shippers as well as for NDM shippers and to promote economic and efficient system operation.

Such redistributive issues require careful consideration and hence Transco welcomes these issues being considered as part of the 0567 Review Group.

11.6 Provision of demand information within day.

SSE "believes that there may also be a need to introduce more frequent updates of the LDZ and DM within day forecasts and demand attribution runs" as "under current Network Code rules Shippers' imbalances would be based on a final NDM Output Nomination generated at approximately 1630, more than twelve hours before the end of the Gas Flow Day."

Transco's response:

Transco understands SSE's concern. Transco also notes that current Network Code provisions (Section H 5.2.4) facilitate additional forecasts to be generated where *"it appears to Transco that the prevailing Forecast LDZ Demand may be substantially inaccurate"*.

Transco notes that Users may wish to have later NDM attribution runs when Modification Proposal 0511 is implemented. Transco would suggest that this issue should form part of discussions within the 0567 Review Group.

11.7 Effects of Modification Proposal 0496 "Improvements to NDM Demand Determination".

LE commented that this Proposal should be implemented to allow time to complete *"work and development"* to *"ascertain exactly what the implications of this [0496] modification are"* as it considers that *"few, if any, shippers fully understand [the level of change to the NDM demand forecasting algorithm], despite the excellent knowledge and skills in the group"*.

Transco response:

Transco is surprised at the apparent level of misunderstanding about Modification Proposal 0496. This Proposal was designed to improve the performance of the demand attribution process by delivering scaling factors (SFs) closer to 1. In several LDZs these have been witnessed to demonstrate significant bias because of variations in year ahead DM forecasts and out turn DM demand. Implementation of Modification 0496 will address this issue. However, Modification Proposal 0496 makes no difference to the demand attribution process used to derive NDM nominations and NDM attributed demand.

Modification Proposal 0496 was developed over a period of months within the Planning and Security Workstream and the Demand Estimation Sub-Committee and received unanimous support both within these groups and from those responding to the consultation process.

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

None

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

None

14. Programme of works required as a consequence of implementing the Modification Proposal

Current systems developments associated with Modification Proposal 0511 would be completed but implementation delayed to reflect any new implementation date established by this Proposal.

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

The current Proposal is to delay implementation of Modification Proposal 0511 "Removal of NDM Forecast Deviation from Imbalance Calculations" until 1st October 2003.

Timetable as follows:

Modification Panel decision ("to consultation")	18/07/2002
Draft Modification Report Published	23/07/2002
Industry Consultation close out	13/08/2002
Final Modification Report published	04/09/2002
Anticipated Ofgem Decision	13/09/2002
Proposed Implementation date	01/10/2003

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation of this Modification Proposal.

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

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 **0563**, version **1.0** dated **04/09/2002**) 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 **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 appropriateprovided 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.