

URGENT Modification Report
Temporary Extension of Absolute Tolerance Quantity
Modification Reference Number 0421

Version 1.0

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.9.3.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because Under Modification 403 '*Further Temporary Extension of Absolute Tolerance Quantity*', which was accepted on 30 May 2000, the Absolute Tolerance Quantity (ATQ) and the Cumulative Imbalance Tolerance Quantity (CITQ) regime was extended until 30 September 2000. Ofgem agreed that it was prudent to sanction an extension to this regime until such time as the new tolerance regime was introduced, otherwise smaller shippers would be unduly exposed to balancing risks, if the ATQ and CITQ were removed prior to the introduction of the tolerance service.

Subsequently, a modification was raised by V-IS-ON Gas, which sought a postponement of the tolerance auctions for a period of six months, Modification 411 '*Postponement of Tolerance Auctions*'. This modification was approved by Ofgem on 4 August 2000. In reaching the decision on urgency, Ofgem has taken into account the imminent removal of the ATQ, with effect from 30 September 2000, and the postponement of the tolerance auctions.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

Issued to Ofgem for decision on urgency	15 August 2000
Proposal agreed as urgent	16 August 2000
Proposal issued for consultation	17 August 2000
Close out for representations	31 August 2000
Final report due to Ofgem	7 September 2000
Ofgem decision expected	14 September 2000

1. The Modification Proposal

The Modification proposes that the Absolute Tolerance Quantity (ATQ) is retained until such time as a tolerance service is made available.

2. Transco's Opinion

Transco is sympathetic to the concerns of shippers that it may be appropriate to retain a fixed level of tolerance, independent of the size of a shipper's throughput, to protect shippers against SMP exposure.

The ATQ and CITQ regime was introduced with the Network Code in March 1996 as a transitional measure. The application of an ATQ has been extended by subsequent Network Code modifications. The current level of ATQ effectively eliminates, or at least substantially reduces, risk of SMP exposure for smaller shippers. The current level of ATQ may therefore act as a deterrent to such shippers seeking balancing tools to achieve a tight supply/demand balance. However, elimination of the ATQ might impose inappropriate risks on shippers that would necessitate trading of very small quantities of gas to avoid SMP exposure which in itself might not be considered to be cost effective.

The Net Cumulative Imbalance (NCI) mechanism rolls forwards imbalances accumulated through the application of the ATQ but sets a limit (the CITQ) on the amount of gas that may be treated in this way. A cashout is applied to gas quantities that exceed the CITQ. Transco considers that application of the CITQ mechanism appears to be inappropriately complex and the roll forward of imbalance from day to day, and the unpredictable nature of the cashout of imbalances beyond CITQ, may present a barrier to the established objectives of facilitating better cost targeting and incentivising shipper balancing.

The original intention of balancing tolerances at the time that the Network Code was implemented was to provide shippers with some protection from SMP cashout so that imbalances arising through genuine operational uncertainty were not unduly exposed. It is possible that shippers are now able to achieve much better control over imbalances and that the degree of operational uncertainty is significantly smaller than that which was anticipated. Hence it is possible that larger shippers (via the ITQ) and smaller shippers (via the ATQ allowance) may have greater imbalance tolerances than are needed to accommodate operational uncertainty. This situation may contribute to less efficient cost targeting in the energy balancing regime.

Transco notes that the Network Code currently provides for the introduction of tolerance services in the future. These services are intended to better facilitate efficient allocation between shippers of such tools for the management of imbalances or balancing uncertainty. Such services would replace the present mechanistic approach that allocates ATQ, CITQ and ITQ to shippers, regardless of specific needs or valuations.

In view of the anticipated introduction of tolerance services in April 2001 Transco advocates that the ATQ is retained. This implementation would involve continuation of the ATQ, but not the NCI and CITQ mechanism. This would be in keeping with the principle of full daily cashout for all gas deliveries without removing the protection afforded by the ATQ. The proposal requests that the ATQ is retained until a tolerance service is made available. The Network Code as amended by modifications 0373 and 0411 will bring a tolerance service into effect on 1 April 2001. As this date is already within the terms of the Network Code Transco believes that it is necessary to specify that the ATQ should have an end date of 31 March 2001.

If a tolerance (or alternative) service is not introduced to be effective from 1 April 2001 then Transco suggests that it would be worthwhile reconsidering the basis of the allocation of imbalance tolerances between shippers.

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

The proposer argues that removal of ATQ without the implementation of an alternative tolerance service may be unduly discriminatory with respect to smaller shippers and that implementation of this proposal facilitates achievement of standard condition 7[c] by "securing the effective competition between relevant shippers and relevant suppliers".

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

No such implications are anticipated.

b) development and capital cost and operating cost implications:

No such implications are anticipated.

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:

Not applicable.

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

No such consequences are anticipated.

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

An extension of the ATQ regime as proposed would require a parameter change in the AT Link system and an additional minor change to system code to set the CITQ to zero. The changes could be made and associated testing completed to facilitate implementation with effect from 1 October 2000 provided Ofgem's decision on whether or not to direct implementation is received within the anticipated timetable.

7. The implications of implementing the Modification Proposal for Users

The ATQ would continue to apply until replaced by tolerance services in April 2001. The CITQ mechanism would cease to exist ensuring that all gas imbalances would be subject to a daily cashout.

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

No such implications are anticipated.

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 such consequences are anticipated.

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

Advantages:

- Continued SMP cashout protection for shippers
- Simplification of administrative arrangements
- Full daily cashout of imbalances

Disadvantages:

- Continuation of a regime that may diminish incentive for shippers to secure
- balancing tools
- Potentially higher costs passed through neutrality than if ATQ were to be
- removed completely

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

16 representations were received. The majority were supportive of this proposal although 3 were strongly against.

The principal reasons cited by supporters of the proposal were:

That the ATQ provides protection to smaller shippers against SMP cashout arising from balancing difficulties associated with genuine operational uncertainties that they may not have the flexibility to mitigate.

That with changes recently made to tolerances and proposals currently being considered to modify the mechanisms for setting cashout prices the removal of ATQ would have the effect of significantly increasing the commercial risks faced by small shippers.

A number of respondents qualified their support and stated that they would expect to see the ATQ cease upon the introduction of alternative mechanisms for shippers to secure tolerance.

Powergen argues that the continuation of ATQ detracts from the fundamental Network Code principle of a daily financial cash-out of gas imbalances. The ATQ was always considered

as a transition arrangement to assist shippers in the early days of the Network Code. The continued extension of the ATQ detracts from the original Network Code vision, and although insignificant from a balancing perspective gives shippers a limited risk free degree of freedom not to daily balance. Scottish and Southern Energy make similar arguments.

Aquila Energy believes that there is ample opportunity for shippers, big and small, to trade out imbalances or purchase requested flexibility to avoid an imbalance position. Scottish and Southern Energy notes that following the introduction of the OCM and the further development of the NBP traded market, that it believes that all shippers now have access to sources of within day balancing gas. Powergen also argues that Shippers build a diversified customer portfolio, use options, contract flexibility and storage to manage risk effectively. As the market matures it does not seem appropriate to Powergen to continue to cross-subsidise those shippers that rely on the ATQ to cover a large proportion of their cash-out risk

Powergen also argues that the ATQ and CITQ calculations add unnecessary complexity to the regime and the removal of the ATQ on 1 October 2000 is a welcome simplification.

Shell Gas Direct states that "Ofgem has been asked to consider maintaining these arrangements twice recently in the form of Modification 386 and Modification 403. On both occasions Ofgem has decided that it better facilitates the relevant objectives to maintain the current arrangements. Ofgem has said that it agrees that small Shippers might be unduly exposed to balancing risks if the Absolute Tolerance Quantity were removed prior to the implementation of a tolerance or linepack service. Shell Gas Direct suspects that this is still the case and that this modification will, therefore, be accepted." Aquila argues that in the interests of market liquidity and regulatory consistency it hopes that ATQs are abolished.

V-is-on argues that in the long-term it would support the replacement of ATQ with a simpler approach. It suggests that in designing a new regime "Ofgem considers increasing the tolerance to small shippers and reducing it for larger shippers, whose tolerance quantities are significantly greater than the actual operational risk they face. Larger shippers tend to have greater flexibility in both gas supply and from interruptible customers than smaller shippers. A regime that better reflects real operational uncertainty and the spread of risk management tools between different types of shippers would be consistent with Transco's objectives to provide reasonable economic incentives and to secure effective competition".

A number of other respondents also state that they would wish to see a permanent solution implemented within the Network Code to provide shippers with a mechanism to secure protection from SMP cashouts that they may face through genuine operational uncertainty.

Transco response

Transco acknowledges the comments made by several respondents that there may be alternative mechanisms to allocate imbalance tolerances between participants so that allowances better reflect operational uncertainties. Transco is, however, sympathetic to arguments that the current SMP cashout protection afforded by an ATQ should be maintained until an alternative mechanism for shippers to acquire appropriate tools to mitigate balancing uncertainties is available. The Network Code will bring a tolerance service into effect on 1 April 2001. Transco recommends that if the date for the commencement of the tolerance service is delayed then the issue of tolerance apportionment should be reconsidered.

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

Not applicable.

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

Some systems changes would be necessary and these would require development and testing. The changes would amend the ATQ end date so that it may continue beyond 1 October 2000 and set the CITQ to zero. It is anticipated that these changes could be completed before 30 September if direction to implement the proposal is received according to the timetable identified above.

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

The proposal is to extend the ATQ until such time as a tolerance service is made available. The Network Code contemplates that ATQ will cease after 30 September 2000. The implementation of a tolerance service was proposed under Modification Proposal 0373 and subsequently deferred to 1 April 2001 by implementation of Modification Proposal 0411. Implementation of this proposal would defer the removal of the ATQ until 31 March 2001, given the introduction of a tolerance service that time.

Therefore the timetable is as follows;

before 30/09/2000	system changes made to ATQ end date.
30/09/2000	CITQ cashed out (actual cashout would appear in September EBI).
01/10/2000	NCI and CITQ parameters set to zero.
01/04/2001	ATQ ceases with implementation of tolerance service.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation as set out in this Modification Report.

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

TRANSITION DOCUMENT, PART II

Amend text at paragraph 1.1 to read as follows:

"....

- (ii) for the purposes of paragraph 6, 31 March 2001 (inclusive)."

Amend paragraph 6.2.3(c) to read as follows:

"....

- (ii) in Phase 2 for Gas Days:

- (1) up to and including 30 September 2000, 7.5% of the arithmetic mean....;
and

- (2) from 1 October 2000 up to and including 31 March 2001, zero."

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

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 **0421**, version **1.0** dated **11/09/2000**) 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.