

URGENT Modification Report
Phased reduction in shipper tolerances
Modification Reference Number 0415

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 in February 2000 Ofgem approved a Modification Proposal for the introduction of tolerance services whereby tolerances would be sold by means of an auction (Modification 0373 : Changes to Shipper Tolerance, Cash-out and the introduction of a Tolerance service). Approval of this proposal was granted on the basis that it would take effect from 1 October 2000. Modification 0411 (Postponement of Tolerance Auctions) was subsequently received, which advocated delaying the introduction of these services until April 2001.

At the time this proposal was raised Ofgem was still to reach a decision on Modification 0411, therefore the first tolerance auction remained scheduled to take place in early September. Ofgem believed that, in these circumstances, any decision on Modification Proposal 0415 would need to be made well in advance of the commencement of the auctions as it will impact upon the amount of tolerance quantities sold.

Further, Ofgem had highlighted concerns in its recent report entitled "The New Gas Trading Arrangements : A Review of the new arrangements and further development of the regime - A review and decision document" regarding the impact of tolerances on Shippers' incentives to balance their positions at the end of the gas day (particularly as significant increases in throughput on the system have mitigated the impact of the reduction in tolerances introduced in October 1999 as part of the New Gas Trading Arrangements). Ofgem believed these concerns also justified granting urgent status to this Modification Proposal.

Procedures Followed:

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

Issued to Ofgem for decision on urgency	15 July 2000
Proposal agreed as urgent	26 July 2000
Proposal issued for consultation	27 July 2000
Close out for representations	10 August 2000
Final Report to Ofgem	16 August 2000

1. The Modification Proposal

The need to strengthen shipper balancing incentives through a tightening of the cash-out regime was one of the key conclusions of phase one of RGTA. More recently concerns about the increase in within-day profiling of gas deliveries and an alleged degradation in the quality of nomination information provided to Transco has again focused attention on shipper balancing incentives. In addition the proposer noted that should Modification Proposal 0411 "Postponement of Tolerance Auctions" be implemented, tolerances will remain at their current levels until 1 April 2001 and another six months will elapse before adequate balancing incentives are introduced. The proposal therefore advocates a phased reduction in shipper ITQ tolerances to maintain the momentum of the original RGTA reforms.

In the proposer's view the current relatively liberal tolerances provide significant scope for shippers to profile deliveries (either intentionally or through poor within-day management of the supply-demand relationship), without facing a significant risk of SMP cash prices at the end of the day. Although the proposal clearly focuses on end-of-day balancing performance, the proposer believes it can indirectly help prevent these within-day profiling problems. By reducing Shipper tolerance, parties profiling within day will find it increasingly difficult to move to an in balance end of day position. The proposer believes that it seems the only approach that can be implemented in the short-term which will offer a realistic prospect of addressing this issue.

This modification proposes that shipper tolerances, which are used to calculate shippers' Imbalance Tolerance Quantity (ITQ), be reduced by 50% from their current levels immediately, and to zero on 1 April 2001.

2. Transco's Opinion

Transco agrees with the proposer that it is desirable to address the concerns that have been raised in respect of shipper balancing behaviour. Transco has observed a greater level of imbalance cashout than might have been expected and believes that it is desirable to enhance the incentive regime so that shippers are encouraged to achieve a closer match between input and offtake from the System. This change would be expected to reduce the amount of balancing activity performed by Transco on behalf of the System and also reduce the potential mis-allocation of balancing costs that can arise through imbalance cash-out.

The proposal advocates a 50% reduction in the tolerance percentages that are used to calculate a shipper's ITQ with immediate effect and a reduction to zero on 1 April 2001. However, Modification Proposal 0411, 'Postponement of tolerance auctions' has been approved and the current ITQ mechanism (that this proposal 0415 modifies) will be replaced by the arrangements described within Modification 0373 on 1 April 2001. The tolerance quantities to be made available through Modification 0373 are not dependent on ITQ regime prevailing before 1 April 2001. If this proposal is approved then it may be desirable to revisit the parameters that define the amount of tolerance to be made available beyond 1 April 2001.

Although the proposal requests an immediate implementation it is Transco's opinion that if approval is granted in sufficient time it is desirable to make the changes to tolerances effective from 1 September 2000.

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

If balancing incentives are increased then this may promote better targeting of residual balancing costs to those causing those costs. It may also promote greater trading between shippers. These improvements might increase efficiency in the commercial mechanisms and better facilitate competition between shippers.

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

If incentives are increased then shipper balancing may improve and this could reduce the requirement for Transco to take balancing actions on behalf of the System.

b) development and capital cost and operating cost implications:

It is anticipated that the implementation of this proposal would involve only parameter changes within Transco systems and costs would be minimal.

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 additional costs will be accounted for under the price control formula.

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

No such consequences are anticipated as imbalance revenues are managed within the Balancing Neutrality Mechanism.

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

The proposal is for a change to parameters within the current tolerance calculation structure and hence no significant development implications are anticipated.

7. The implications of implementing the Modification Proposal for Users

Shippers will be incentivised to achieve a closer balance between input and output to avoid the risk of having any excess imbalance outside tolerance cashed out at SMP price.

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;

Increased shipper incentives to achieve balance by end of day

May increase incentive to reduce flow profiling within day

Greater incentives for shipper to shipper trading of imbalances

Reduced opportunity for shipper to Transco (acting on behalf of System) trading via cashout

Disadvantages;

Increased risk resulting through imbalance

Potential disproportionate effect on smaller shippers

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

There were 13 representations submitted in response to this proposal. The majority did not support implementation of the proposal but several expressed limited support and three offered full support.

The issues raised in representations are considered below under the following headings; Size of reduction, Access to alternatives, Shipper balancing incentives, Within-day profiles. Under each heading the representations are summarised and a Transco response is given.

Size of Reduction

Scottish Power supports the phased reduction in Shipper tolerances. Aquila suggests that tolerances should be fully removed from October 2000. BGT supports a reduction of 50% effective from the proposed date but does not support a contraction to zero with effect from 1 April 2001 whilst there is uncertainty regarding the replacement of tolerances.

Transco response

Analysis shows that despite the 25% reduction in tolerance percentages that was applied with the implementation of RGTA the actual reduction in tolerance quantities that has been achieved has been negligible as a result of the effect of increased throughput. As demonstrated in the 'Review of Winter Operations', shipper imbalances are now greater than they have been in the past. This indicates an increased level of enforced shipper to Transco gas trading via the cashout mechanism. Transco is concerned that the tolerance amounts should continue to increase when it appears that tolerance could be used to extract commercial value from the regime rather than to address the operational uncertainty associated with individual Shipper imbalances.

Transco also has concerns that whilst the aggregate amount of imbalance tolerance available continues to increase in line with load growth the capability of the System to accommodate a supply / demand imbalance remains fairly constant.

Access to alternatives

BP states that it does not support any further reduction in tolerance levels as there is no alternative currently available to enable shippers to acquire the necessary tolerance levels e.g. Linepack service/Tolerance service. Alliance Gas makes a similar observation.

Scottish Power believes that with the postponement of the tolerance service to April 2001 this proposal is a timely step in the right direction.

Shell points to the recent acceptance of Modification Proposal 0411 and argues that the management of within day risks should be solved through a linepack service. Shell states that it does not expect that there will be changes to the tolerances currently available whilst that service is being developed.

SSE is concerned by proposals to reduce/remove shippers' balancing tolerances without substitute. It argues that tolerances were a key concept during the negotiations of the Network Code recognising that it is virtually impossible for shippers to balance to zero given the uncertainties of the offshore allocation process and the lack of real-time supply/demand information. SSE believes an alternative option is to permit shippers to trade their imbalance tolerances with each other.

Total considers that the current tolerances are already insufficient to accommodate typical NDM and DM deviations and the difference between NDM / DM nominations and allocations. It considers it inappropriate to reduce tolerance quantities until shippers are able to acquire sufficient levels of tolerance to cover their portfolio requirements via the (Modification Proposal 0373 and subsequent Modification Proposal 0411) auction of the existing tolerance quantities in April 2001.

Transco response

Transco is not convinced by arguments that there are no alternatives to imbalance tolerances for shippers. It remains the case that shippers may trade gas quantities to avoid the risk of imbalance cashout at SMP. Indeed it may be considered preferable that shippers should trade between each other rather than trade via the cashout mechanism.

Transco recognises that tolerances were introduced to provide a degree of protection against operational uncertainties. However, Transco believes that analysis of Shippers' balancing performance may indicate that the allowed tolerance is greater than that required to mitigate these uncertainties. The protection provided through the NDM deviation adjustment would not be reduced as a result of implementing this Modification Proposal, which Transco believes addresses the concerns in respect of NDM deviations.

Shipper balancing incentives

BP does not support the proposal although it agrees with the principle of incentivising shippers to better balance their portfolios. Total makes a similar comment. Total goes on to discuss the derivation of the cash-out prices from the OCM and the risk that the current regime may deliver 'out-of-market' prices.

Alliance argues that any reduction in balancing tolerances alone is unlikely to facilitate a reduction in balancing costs as end of day imbalance positions are not necessarily reflective of any costs created on the system during the day.

TXU believes that a reduction in shipper tolerances will not improve shippers' balancing behaviour. It argues that there is little evidence to suggest that the previous 25% reduction in tolerances has led to a reduction in balancing charges and that a further reduction could not therefore be guaranteed to have the desired effect in reducing costs. It argues that with a reduced tolerance shippers may be encouraged to change imbalance position later in the day, forcing Transco to use the OCM at a time when liquidity is most limited.

Aquila believes that removal of tolerances should provide better incentives to shippers to balance their portfolios, lessen cost misallocation arising from shippers being able to trade out tolerances and reduce balancing neutrality costs. It agrees with the Ofgem conclusion that "the continued presence of tolerances may be having a significant impact on levels of OCM trading and market liquidity".

Shell links this proposal with the previous proposal number 0381. Ofgem rejected that proposal and stated at the time that it "might not necessarily enhance shipper end-of-day balancing behaviour, or lower system aggregate balancing costs".

V-is-on gas believes that the proposal is unduly discriminatory against the interests of smaller shippers with less flexible portfolios that cannot respond to a tighter tolerance.

SSE states that the reduction in tolerances would have a fundamental effect on Transco's use of linepack to manage its system as well as on Transco's energy balancing incentive. SSE considers that Transco's balancing actions are influenced by shippers' behaviour. SSE is unclear what would happen to the tolerance volume that is 'taken away' from shippers and notes that there is no clear indication as to the extent to which Transco's incentive would be modified. BGT also considers that in order to provide shippers real incentives to balance then the Transco energy balancing incentive requires amendment. BGT notes that the regime may still generate weak incentives when the SMP is set equal to SAP in the event that there is no balancing action in a particular direction.

Transco LNG considers that a reduction in tolerances would encourage improved balancing performance, with a corresponding decrease in system balancing costs. Better cost targeting would also encourage the development of alternative balancing services, better aligned to shipper requirements and to the capabilities of physical facilities.

Transco response

The intention of the RGTA modifications was to increase the incentive arrangements to encourage a reduction in shipper imbalances. This was expected to better target balancing costs to those that have caused those costs to be incurred. It was anticipated that a first step improvement would be achieved by a 25% reduction in shipper imbalance tolerances. The calculation of tolerance is made as a percentage of gas throughput measured at input and output points. In fact what has occurred is an increase in throughput that has effectively offset the effects of the reduction in tolerance percentage. Transco believes that it is desirable to make a further reduction in the tolerance calculation formula to provide appropriate incentives for shippers to balance. This proposal maintains a non discriminatory method of allocation but Transco recognises that smaller shippers may face greater difficulty in achieving a balance within tolerance than large shippers with greater diversity of supply and demand. Changing the allocation method is, however, beyond the scope of the Modification Proposal.

Transco believes that the incentive regime was constructed on the premise that Transco performs a role as the 'Residual Balancer' of the System. Transco has expressed concern that it has observed shipper balancing behaviour that is different to that prevailing before the introduction of RGTA. Transco considers that taking this change in addition with the current aggregate quantity of imbalance tolerance available to shippers is likely to have led to System balancing costs that are higher than would otherwise have been experienced.

The proposal to alter the parameters of shippers imbalance tolerance within the existing structure of the ITQ calculation provides a realistic option that is achievable for 1 October 2000 with minimum impact on both Transco and shipper systems.

Within day profiles

Aquila believes that the removal of end-of-day tolerances will not solve the issue of within-day cost misallocation. It suggests a number of alternative ways in which within-day problems might be addressed.

Alliance believes that those shippers with the ability to profile, as they have access to swing gas are unlikely to change their behaviour as a result of a reduction of end of day balancing tolerances.

V-is-on agrees that the issue of within-day balancing does need to be addressed but believes that a regime could be better designed to incentivise those shippers that are profiling while recognising that shippers with less predictable portfolios should not face significantly higher balancing charges. V-is-on suggests two changes that it believes would better address within day profiling. Firstly a change to the cash-out regime and secondly an alternative method for the determination of tolerance.

SSE does not believe that this proposal will help prevent the within-day profiling problem. It states that the lead times required by offshore operators to increase flows are significantly greater than those to reduce flows. It suggests that this predisposes shippers to holding long positions through the gas day and nominating down to achieve end-of-day balance. SSE goes on to argue that the only means of addressing profiling is to improve within day information flows. It notes the differences in the arrangements under which within-day flow information is provided to Transco.

BGT considers that by itself a reduction in tolerances will not necessarily achieve the desired effect of reducing profiling although it is a step in the right direction.

Transco response

Whilst a reduction in end-of-day balancing tolerances may not directly lead to an incentive to nominate and flow at a constant rate throughout the day it may provide an indirect benefit. If the balancing tolerance for a Shipper is reduced then the commercial risks associated with flowing gas at other than uniform hourly flow rates will increase.

There are a number of potential remedies that could more directly discourage within-day profiling but these are generally more complicated and would require some development effort before they could be implemented. This proposal might provide an early and helpful step towards reducing profiling.

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 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 3(5) or the statement furnished by Transco under Standard Condition 3(1) of the Licence

Not applicable

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

As no significant changes are anticipated to be required to UK Link systems a programme of works is not provided.

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

The proposal is for an immediate implementation but in order to provide Shippers adequate notice of the change to tolerance levels Transco recommends that this proposal is implemented with effect from 1 September 2000 and that the proposed parameter changes take effect from 06:00hrs on that day.

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation of this 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 Director General in accordance with this report.

19. Text

Section F.2.2 Imbalance Tolerance Quantity

2.2.1 a. delete text and insert “ not used “

2.2.2 amend to read “ The Applicable Imbalance Percentage shall be zero .”

Transition Document Part II

Paragraph 8.4.4. delete and insert new paragraph 8.4.4 as follows ;

“8.4.4. F.2.2.2 Until 31st March 2001 the Applicable Imbalance Tolerance Percentage shall be ;

- (i) 1.125% in respect of the System Exit Points (other than NDM Supply Point Components or NDM Supply Point Components where the Annual Quantity of the Supply Point is less than 58,600,000 kWh (2,000,000, therms) and Relevant Connected System Exit Points (which shall include Storage Connection Points of any Storage Facilities);
- (ii) 3% in respect of DM Supply Point Components where the Annual Quantity of the Supply point is less than 58,600,000 kWh (2,000,000 therms);
- (iii) 0.75% in respect of System Entry Points.

Signed for and on behalf of Transco.

Signature:

Tim Davis

Manager, Network Code

Date:

Director General of Gas Supply Response:

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0415**, version **1.0** dated **21/08/2000**) be made as a modification to the Network Code.

Signed for and on Behalf of the Director General of Gas Supply.

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 Director General of Gas Supply ("the Director") 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 Director 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 Director does not so approve the Agreement then Clause 3 shall apply.
2. If the Director 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 Director 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 Director 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 Director 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.