

22 August 2000

BG Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/0415

Dear Colleague,

Modification Proposal 0415 'Phased Reduction in Shipper Tolerances'

Ofgem has considered the issues raised in Modification Proposal 0415: '*Phased Reduction in Shipper Tolerances*'. Ofgem has decided to direct BG Transco to implement the modification, because we believe that this proposal will better facilitate the relevant objectives of BG Transco's Network Code.

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

Background to the proposal

Imbalance Tolerance Quantity (ITQ) is a percentage throughput allowance, applied to shippers, to enable them to deviate from their end of day balance without being 'cashed out' at system marginal prices. Shipper imbalances can occur due to inaccurate forecasts, unexpected demand changes and incomplete information from off-take sites. The tolerance is applied on the basis of shipper portfolios to reflect information uncertainties. On average it is equal to 3% of throughput.

During the discussions leading up to the implementation of the New Gas Trading Arrangements in October 1999, Ofgem stated its belief that shipper balancing performance is more likely to be improved by the removal of tolerances. However, Ofgem made clear that, in its view, the complete removal of balancing tolerances should be linked to the introduction of a commercial linepack service by BG Transco. This service would allow shippers to buy linepack, or storage in the pipeline system itself, from BG Transco to manage the risks associated with imbalances and enable shippers with different flow profiles to value the flexibility associated with linepack and potentially to trade it.

In this regard in its May 1999 document entitled '*The New Gas Trading Arrangements*' Ofgas indicated that it would prefer a 50% reduction in tolerances from 1 October 1999 with half of the reduction being tendered back to shippers in the form of a tolerance service. Ofgas indicated that it would expect a full removal of tolerances from April 2000 to coincide with the commencement of a linepack service.

Ofgas stated that, if BG Transco was unable to organise a tolerance tender in time for October 1999, there should be a 25% reduction in tolerances from 1 October 1999 and a complete removal from April 2000 when a linepack service was to be introduced. As events progressed, it became apparent that a tolerance service could not be introduced in October 1999. As a consequence ITQs were reduced by 25%, with a view to their complete removal by April 2000 to coincide with the introduction of linepack/tolerance services.

On 28 February 2000, Modification 373 '*Changes to Shipper Tolerance, Cash-out and the introduction of tolerance services*', was signed off by Ofgem in its decision document entitled '*The New Gas Trading Arrangements: further development of the regime*'. The modification allowed for the introduction of auctions for under-delivery and over-delivery tolerances, through a monthly and day-ahead auction. Whilst we made it clear that we saw merit in

introducing tolerance auctions, we anticipated BG Transco introducing a linepack service for October 2000. As a result, we agreed to the implementation of Modification 373 from 1 October on the proviso that it would only be implemented if a linepack service had not been developed by this date. In reaching this decision we recognised shippers' concerns that the operation of a tolerance service for a brief period would involve unnecessary administrative costs. The auctions for tolerances were scheduled to take place in early September 2000.

In addition to considering Modification 373 in its February decision document Ofgem also decided upon Modification 381 '*Reduction in Shipper Tolerances Used to Calculate Shipper ITQ*'. This modification proposed for tolerances to be reduced to zero over the period April 2000 to April 2001 and was rejected by Ofgem. Ofgem concluded that a 25% reduction of tolerances in April 2000 might not necessarily enhance shipper end of day balancing behaviour, or lower system aggregate balancing costs. Ofgem was also reluctant to approve a reduction in the flexibility available to shippers through tolerances, when this flexibility could potentially be increased in October 2000 under a linepack service.

On 3 July 2000, V-IS-ON Gas raised a modification, Modification 411 '*Postponement of Tolerance Auctions*', which proposed the postponement of the auctions for a six-month period. The proposal envisaged further refinements to the rules for the auctions being necessary.

We accepted this modification on 3 August 2000. Our decision to agree to the postponement was based on a number of reasons. First, we reiterated our belief that a tolerance service should only be implemented in the absence of a linepack service and that the development of a linepack service should remain a priority. Second, our review document of July 2000 entitled '*The New Gas Trading Arrangements: A review of the new arrangements and further development of the regime, A review and decision document*' provided evidence that some shippers are using tolerances rather than trading out their imbalances in the market. This could keep gas from the market and have an adverse impact on liquidity on the OCM. Third, we had concerns that tolerances could contribute to within-day profiling activity as shippers may be taking significant imbalances positions within day to force Transco into taking balancing actions. Shippers would then be able to end the day in an imbalance position by delivering long into their tolerances and cashing out at a higher SAP price that was influenced by Transco's balancing action.

In this context we indicated in our decision letter that a tolerance service that allows shippers to purchase tolerances would not significantly increase the incentive on shippers to balance. In addition, Ofgem also recognised concerns expressed by some respondents to the proposal that the introduction of a tolerance service for only an interim period could unnecessarily increase the administrative burden on shippers to manage their portfolios.

The modification proposal

It is proposed that shipper tolerances, which are used to calculate shippers ITQ, should be reduced by 50% from their current levels immediately, and to zero from 1 April 2001.

Respondents' views

Whilst the majority of respondents did not support the implementation of this modification, most agreed with the principal of incentivising shippers to improve their balancing performance. Some respondents raised concerns that the proposal could be discriminatory against smaller shippers, since those shippers have less flexibility than the larger players. One shipper felt that no further change should be introduced until such time as tolerance or linepack services are introduced, otherwise smaller shippers will be disadvantaged, as they will have less flexibility.

Generally, respondents did not believe that this modification would solve the problem of within day profiling. One respondent indicated that a reduction in tolerances may actually lead to increased profiling.

Some respondents suggested that the cash out regime and BG Transco's energy balancing incentive needs to be changed to achieve the objective of better balancing. One respondent raised concerns that the implementation of this modification could have an adverse impact on liquidity on the OCM, as there would be a greater risk associated with delivering gas.

Those who supported the proposal did so in the belief that it would encourage improved balancing performance. One respondent agreed with the immediate 50% reduction, however it did not support reducing tolerances to zero by 1 April 2001.

Ofgem's View

In its July 2000 document entitled Ofgem concluded that shipper imbalances have increased significantly in the past year and that shipper use of tolerances has also increased. This has occurred despite the 25% reduction in imbalance tolerances that occurred in October 1999. In this regard, analysis undertaken by Ofgem also indicates that increases in system throughput since October 1999 have effectively reduced the original 25% reduction in ITQs to a reduction in aggregate of 12% in absolute terms.

Further, Ofgem considers that there is evidence to suggest that some shippers are using their imbalance tolerances for commercial purposes to avoid trading out imbalances. Ofgem believes that this is inconsistent with the intent behind the tolerance regime to provide limited relief from marginal cash-out prices in recognition of the uncertainties shippers can face in achieving an end of day balanced position. In particular, Ofgem believes that the current tolerance regime when combined with the existing cash-out regime is effectively encouraging shippers to take imbalance positions. On days where BG Transco takes a large volume balancing action at the beginning of the day that effectively sets the SAP, shippers have an incentive to maintain an end of day imbalance position within tolerance levels and be cashed out. If shippers trade out the imbalance at any lower price in the market this would effectively reduce the SAP. Ofgem is concerned that this behaviour is effectively leading to increased shipper imbalances, a need for more balancing actions by BG Transco and may be discouraging trading and reducing liquidity in the prompt markets including the OCM.

As outlined in our decision on Modification 411, '*Postponement of Tolerance Auctions*' Ofgem also have concerns that the existing tolerance regime may be encouraging shippers to profile deliveries within day to influence BG Transco's balancing actions by sending the system short early in the day to force BG Transco into a balancing action. Shippers would then be able to end the gas day in an imbalance position by delivering long into their tolerances and cashing out at the higher SAP that was influenced by the BG Transco balancing action. In these circumstances Ofgem is concerned that tolerances may be contributing to within-day profiling activity as they provide the shippers who engage in these activities greater certainty that they will not be made to bear the costs of these imbalances at the end of the day.

Ofgem therefore believes that a reduction in tolerance levels should provide sharper incentives on shippers to trade out their imbalances, further reducing the amount of system balancing BG Transco needs to undertake. The reduction in tolerances should therefore improve balancing performance and lead to a decrease in balancing costs.

Ofgem does not believe that an acceptance of this proposal would be inconsistent with its treatment and rejection of Modification 381. Ofgem believes that the recent review of the first few months of operating under the New Gas Trading Arrangements, which set out the results of our analysis of shipper balancing and the commercial use of shipper tolerances, has

demonstrated that the way in which shippers are using tolerances has changed and that this may be putting upward pressure on prompt gas prices.

Ofgem does not agree with the arguments put forward by some shippers that a reduction in tolerances would discriminate against small shippers. Instead Ofgem believes that it is desirable to provide all shippers with incentives to purchase and obtain flexibility through the market rather than simply allocating this flexibility to shippers at no cost. Ofgem also notes in this context that ATQs currently provide smaller shippers with some protection against imbalance risks and costs. Ofgem will shortly consider Modification Proposal 421, '*Extension of Absolute Tolerance Quantity*' that proposes an extension to the existing ATQ regime.

Further, Ofgem would also encourage BG Transco and shippers to work together in the next few months towards the development of a full linepack service from 1 April 2001. Ofgem believes that this service should provide all shippers with access to an additional flexibility tool to assist in the management of imbalance risks.

Ofgem recognises the concerns expressed by some shippers about an immediate implementation of this proposal and the need to provide shippers sufficient time to adjust to a further reduction in tolerances. Ofgem therefore proposes to delay the implementation of the initial 50% reduction in tolerance until 1 October 2000. Ofgem believes that this delay will provide shippers with sufficient notice of the change, given the extensive debate on the need to remove imbalance tolerances as part of the NGTA programme and the earlier postponement of the planned removal of tolerances.

Ofgem's Decision

Taking all the considerations above in to account, we have decided to consent to this modification, as we believe that it better facilitates the relevant objectives as outlined under Standard Condition 7 of BG Transco's Public Gas Transporters' licence. In particular, Ofgem believes that by sharpening shipper incentives to balance and thereby potentially reducing balancing costs the modification will better facilitate the efficient and economic operation of the NTS.

Further, Ofgem considers that the modification better facilitates the objective of securing effective competition between relevant shippers and between relevant suppliers. Currently, those shippers who are using their tolerances for commercial purposes to avoid trading out their imbalances can effectively buy gas from or sell gas to the system at SAP rather than a market determined price. The costs associated with any BG Transco balancing actions taken to address these commercial imbalances are then smeared back to all shippers. Ofgem therefore believes that a reduction in tolerance levels should improve cost targeting and ultimately reduce the level of smeared costs. This should assist in securing effective competition between relevant shippers and suppliers.

This modification should take effect from 1 October 2000.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Mark Feather

Head of RGTA