

Direct Dial: 020-7932-5927

12 September 2000

BG Transco, Shippers and Other Interested Parties

Your Ref:

Our Ref : Net/Cod/Mod/0421

Dear Colleague,

Modification Proposal 0421 'Temporary Extension of Absolute Tolerance Quantity'

Ofgem has considered the issues raised in Modification Proposal 0421 '*Temporary Extension of Absolute Tolerance Quantity*'. 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

Absolute Tolerance Quantity (ATQ) and Cumulative Imbalance Tolerance Quantity (CITQ) were introduced as a transitional arrangement with the Network Code to ensure that shippers out of balance by an absolute value of 7,500 therms were protected from SMP 'cash-out' exposure. Shippers were also entitled to an imbalance tolerance quantity. As part of the New Gas Trading Arrangements, Ofgem has consistently argued for the phased removal of shipper imbalance tolerances to sharpen the incentives on shippers to balance. Ofgem has also advocated the sale of system linepack, via a price auction, to provide an alternative based on the underlying physical flexibility of the pipeline system itself.

The implementation of Modification 313 '*Development of the Energy Balancing Regime to facilitate implementation of the on-the-day commodity market*' saw a reduction in shipper imbalance tolerances of 25% from 1 October 2000. In February 2000 Quantum Gas Management (now V-IS-ON Gas) raised Modification Proposal 0386 '*Temporary Extension of Absolute Tolerance Quantity*' seeking an extension of the ATQ and CITQ regimes until such time as a tolerance service was made available. At that time existing ATQ and CITQ requirements were scheduled to expire on 29 February 2000. In raising Modification 0386, Quantum argued that smaller shippers would be disadvantaged by the removal of ATQs, as these shippers tend to have fewer daily metered (DM) sites and tend to source their gas from the National Balancing Point (NBP). As such, these smaller shippers may be subject to higher within-day demand swings and therefore, face a greater risk of SMP 'Cash Out' exposure. Ofgem subsequently directed that Modification 0386 should be implemented on 28 February 2000.

As Modification 0386 was being prepared, BG Transco had proposed through Modification 373 '*Changes to Shipper Tolerance, Cash Out, and introduction of Tolerance Service*', that a tolerance service should be introduced on 1 June 2000. As such, the legal text of Modification 0386 that Ofgem accepted merely specified an extension of ATQs until 31 May 2000. However, in reaching its decision on Modification 0373 in February 2000, Ofgem directed that Transco should delay the implementation of a tolerance service from 1 June to 1 October 2000. As a result Transco raised Modification 0403 '*Further Temporary Extension*

of *Absolute Tolerance Quantity*' which sought to provide for a further extension of the ATQ and CITQ tolerance regime until 30 September 2000. Ofgem subsequently approved this modification, in view of the delay in introducing a tolerance service.

Subsequently V-IS-ON Gas raised Modification 411 'Postponement of Tolerance Auctions, which advocated the postponement of the tolerance auctions for a period of six months. This modification was accepted by Ofgem on 4 August 2000. In addition, Ofgem accepted Modification 0415 '*Phased Reduction in Shipper Tolerances*', on 22 August 2000, which has led to a 50% reduction in imbalance tolerances from their existing levels. Imbalance tolerances will be reduced to zero from 1 April 2001. Ofgem agreed to this reduction because we concluded in our July 2000 document entitled '*The New Gas trading Arrangements: A Review of the new arrangements and further development of the regime; A review and decision document*,' that shipper imbalances had increased significantly over the last year despite the 25% reduction in tolerances that occurred in October 1999. Further, Ofgem believed that shippers are using tolerances for commercial purposes to avoid trading out imbalances. We believed that this is inconsistent with the intent behind the imbalance regime, which was to provide limited relief from marginal cash out prices in recognition of the uncertainties shippers faced in achieving an end of day imbalance position.

The modification proposal

It is proposed to retain the ATQ until such time as a linepack service is introduced by Transco. For the avoidance of doubt, this modification does not seek to extend CITQs, therefore, CITQs will no longer exist as from 1 October 2000.

Respondents' views

The majority of respondents were in support of the temporary extension of the ATQ regime, with some respondents opposing the removal of ATQs from the Network Code. Some respondents believe that in order to encourage competition, smaller shippers should be afforded some protection from System Marginal Prices that they may face through operational uncertainty. One respondent suggested replacing, in the long-term, the ATQs with an approach that reflects the poorer availability of risk management tools and the higher operational uncertainty encountered by smaller shipper relatively to larger ones.

Three respondents strongly opposed this modification. They believed that all shippers have ample opportunity to trade out imbalances and to manage risk effectively. One of the three opponents maintained that it is inappropriate to continue to cross-subsidise those shippers that rely on the ATQs to cover large portions of their cash-out risk.

Ofgem's View

Ofgem supports the further extension of ATQs, until such time as a linepack service is introduced, as we believe that small shippers may be unduly exposed to balancing risks if the ATQ is removed prior to the introduction of alternative flexibility tools such as a linepack service. Ofgem believes that this is consistent with its decision to approve Modification 386 in February 2000, which extended ATQs and CITQs, until 31 May 2000, when it was expected that a tolerance service would be introduced. Our decision is also consistent with our acceptance of Modification 0403, which further extended ATQs and CITQs until 31 September 2000, as it was expected that a tolerance service would be introduced from 1 October 2000. Ofgem does not believe that the acceptance of this modification in any way leads to a cross-subsidy across shippers, as ATQs will apply to all shippers not just smaller shippers and all shippers will still have imbalance tolerances until April 2000. The combination of imbalance tolerances and ATQs are unlikely to exceed the underlying physical flexibility of the NTS in the absence of a linepack service.

Ofgem's Decision

Taking all the considerations above in to account, we have decided to consent to this modification, as we believe that it conforms to the relevant objectives of BG Transco's network code, in particular; the securing of effective competition between relevant shippers and relevant suppliers, because in the absence of a linepack service smaller shippers could be disadvantaged by being exposed to greater risk in their balancing activities.

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,

Steve Smith
Director, Trading Arrangements