

Direct Dial: 020 7901 7374

24 September 2002

Shippers, Transco and Other Interested Parties

Your Ref:

Our Ref : Net/Cod/Mod/563

Dear Colleague,

Network Code modification proposal 563 “Delay to the Removal of NDM Demand Forecast Deviation Tolerance”

Ofgem has considered the issues raised in Network Code modification proposal 563 “Delay to the Removal of NDM Demand Forecast Deviation Tolerance”. Ofgem has decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the achievement of the relevant objectives of Transco’s Network Code.

In this letter, we explain the background to the modification proposal, the nature of the modification proposal, summarise respondents’ views, summarise Transco’s views, give the reasons for Ofgem’s decision and confirm Ofgem’s decision.

Background to the proposal

The current gas balancing regime provides incentives to shippers to balance their inputs and offtakes to Transco’s National Transmission System (NTS) by the end of the gas day. If a shipper inputs less gas onto the NTS system than it has offtaken, it is short gas and pays Transco the System Marginal Buy price (SMPbuy) for the gas it

is short. SMPbuy is set by the greater of the highest priced buy trade by Transco on the gas day or the System Average Price (SAP) plus a fixed differential. If a shipper's inputs are greater than its offtakes, it is long gas and receives from Transco the System Marginal Sell price (SMPsell) for the gas it is long. SMPsell is set as the lower of the lowest price Transco sell trade on the gas day or the SAP less a fixed differential. The net cost or revenue of the cash out regime is passed to all shippers based on their throughput of gas on the NTS as part of the neutrality charges.

Prior to the implementation of the New Gas Trading Arrangements from 1 October 1999 it was agreed that shippers should be given some relief from cash out at marginal prices to recognise the difficulty for shippers of managing some of the risks associated with balancing. A range of tolerances were implemented which cashed shippers out at SAP up to the limits of the tolerances and System Marginal Prices for imbalances greater than the tolerances. As a consequence of concerns that shippers were using tolerances for commercial advantage rather than to mitigate unmanageable risks, some of the tolerances have been removed since October 1999. The only remaining tolerance is for differences between Transco's NDM demand forecast and shippers' allocation of demand for imbalance cashout.

In December 2001 Transco raised Network Code modification proposal 511 "Removal of the NDM forecast deviation tolerance". This modification was approved by Ofgem on 2 May 2002 for implementation on 1 October 2002. In approving the modification, Ofgem explained that it believed that the removal of the tolerance would provide shippers with better incentives to manage imbalance risks because all imbalances would be cashed out at System Marginal Prices. Ofgem explained that it believed that competition between shippers would be better facilitated because to the extent that some shippers were better able to forecast demand than other shippers or Transco they would obtain a commercial advantage. Ofgem also stated that the tolerance may constitute a cross subsidy from shippers at DM sites to shippers at NDM sites because shippers at DM sites do not have any tolerance.

In June 2002, Network Code modification proposal 553 "Amendment of imbalance calculations to enable effective aggregation of demand across one or more shipper"

was proposed. This would allow a shipper to nominate demand on behalf of a number of shippers. Transco has stated that at the Network Code meetings to discuss the modification proposal that it would not have the IT capability to implement the modification proposal until October 2003.

This month Network Code review group 567 “Review of NDM demand forecasting methodology” was set up to consider what changes are necessary to allow shippers to better forecast demand for their NDM portfolios and to manage the risk of demand forecasting errors.

The modification proposal

Network Code modification 563 proposes that the implementation of Network Code modification 511 “Removal of the NDM Forecast Deviation Tolerance” is delayed until October 2003.

Respondents’ views

There were ten responses to the consultation for Network Code modification proposal 563. Eight respondents supported the modification proposal, while two respondents did not support the modification proposal.

A number of shippers stated that even if they were better able to forecast NDM demand than Transco, they had no means of informing Transco that they were not using Transco’s NDM demand forecast, which could create uncertainty for Transco, leading to it taking unnecessary balancing actions. These shippers suggest that a delay in implementing Network Code modification 511 could provide sufficient time to develop a process for shippers to notify Transco of their NDM demand forecasts.

Two shippers stated that it was unclear whether, following the implementation of Network Code modification 511, shippers would be expected to forecast their own NDM demand or forecast their D+5 NDM allocation.

Shippers argued that elements of Transco's demand forecasting are outside their control, and in particular the dependency of NDM forecasting on DM nominations. Shippers argued that without a tolerance for the NDM demand forecast deviation, cashout prices of SMP for NDM imbalances would not be cost reflective of an imbalance that shippers could not effectively manage. One shipper argued that the NDM demand forecast deviation tolerance provides shippers with protection from exposure to higher cashout prices while giving Transco the certainty of information in relation to a shipper's imbalance position. Some shippers argued that they had misunderstood the intention of Network Code modification 496 "Improvements to NDM demand determination". Shippers stated that they had originally believed that the proposal would forecast NDM demand independently of DM nominations.

Some shippers argued that implementation of Network code modification 511 would be to the advantage of Centrica only as they have a competitive advantage in forecasting NDM demand. Shippers also argued that was possible that BGT could benefit through neutrality charges from high cashout prices for those shippers unable to manage NDM imbalance.

Some shippers argued that the removal of the NDM demand forecast deviation tolerance would lead to over delivery of gas by shippers to mitigate against the risk of imbalance charges unless they have additional time to improve demand forecasting techniques.

One shipper stated that following Ofgem's decision to accept Network Code modification 511, it requested information from Transco to assist shippers in forecasting demand. The shipper stated that Transco had produced only around 20 to 30% of this information, which was requested in June. Other shippers recognised that Transco had been forthcoming in providing information.

One of the shippers who did not support Network Code modification proposal 563 stated that there no new factors that had been introduced since Ofgem made its decision to accept Network Code modification 511 in May. One shipper argued that

in its decision letter, Ofgem noted that an implementation date of 1 October 2002 would provide sufficient time to prepare for the removal of the tolerance.

One shipper noted that changes in NDM forecasts within day represent changes in the level of offtakes associated with NDM loads. The shipper believed that the removal of the tolerance would provide incentives for shippers to track NDM demand nominations and to respond to the revised forecasts. If the implementation of Network Code modification 511 was delayed, it argued that shippers who did not respond to the revised forecasts could effect balancing actions by Transco on their behalf which would be passed on to those DM shippers out of balance at the end of the day who did not have the protection of a demand forecast tolerance. The shipper believed that the tolerance would lead to a cross subsidy between those shippers with NDM sites and those without. Another shipper believed that without the existing tolerance and given the current cashout regime, there would be a cross-subsidy from shippers with NDM sites to shippers with DM sites.

One shipper noted that NDM shippers would continue to receive NDM demand forecasts from Transco, which they could choose to rely on. However, they would be incentivised to trade out forecast end of day imbalances as Transco forecasts changed through the day. One shipper questioned whether it was economic and efficient for all shippers to be incentivised to replicate work on demand forecasting, which Transco carries out.

Some shippers believed that the tolerance should be removed only after the mod 567 review of NDM forecasting methodology has been given due consideration. One shipper did not believe that it was necessary for the Network Code review group 567 to delay the removal of the tolerance.

Transco's views

Transco believed that operationally it would be more appropriate to delay the removal of the NDM demand forecast deviation tolerance. In particular, it was concerned that shippers may have weaker incentives to track NDM demand

nominations, but greater incentives to balance supply and demand. It believed that this could have detrimental implications on operational balancing efficiency.

Subsequent to the modification report, Transco has stated to Ofgem that it has provided shippers with all of the information it was requested to provide about demand forecasting.

Ofgem's view

Ofgem continues to believe that the decision to implement Network Code modification 511 better facilitates the achievement of the relevant objectives of Transco's Network Code, for the reasons set out in the decision letter of 2 May 2002. It is for shippers to decide whether to use Transco's demand forecasting or to forecast their own allocation of demand for cashout. It is also for Transco, consistent with its obligations as a gas transporter, to determine how best to forecast overall system demand to determine its own balancing actions. The implementation of Network Code modification 511 also better aligns the gas and electricity regime, because in electricity, market participants do not have the benefit of demand forecasting tolerances.

In deciding whether or not to consent to Network Code modification proposal 563, Ofgem has considered whether there are any reasons why it is appropriate to delay the implementation of Network Code modification 511.

In Ofgem's decision letter for Network Code modification 511, we stated that Ofgem believed that Transco should make available information to assist shippers in forecasting demand. Following discussions with shippers, Ofgem considers that Transco has provided to shippers all of the information that was requested by shippers.

In approving Network Code modification 496, Ofgem considered analysis provided by Transco to show that the modification would improve demand forecasting. If shippers believe that further improvements can be made to Transco's demand

forecasting they can raise Network Code modification proposals or discuss the issues in Network Code review group 567.

Ofgem is participating in Network Code review group 567, and will consider the conclusions reached by the review group and any Network Code modifications proposed following discussions in the group. Ofgem does not believe that the review group process should necessarily delay the implementation of Network Code modification 511, but Ofgem would carefully consider any proposals raised by the review group regarding NDM demand forecasting.

Ofgem believes that shippers have had sufficient time to prepare for the implementation of Network Code modification 511 from 1 October 2002, and does not believe that a delay in the implementation of this proposal would better facilitate the achievement of the relevant objectives of Transco's Network Code. For the reasons explained above, and in the letter of 2 May 2002, Ofgem believes that Network Code modification 511 better facilitates the relevant achievement of the relevant objectives of Transco's Network Code.

Ofgem's decision

For the reasons explained above, Ofgem has decided not to consent to this modification, as we do not believe that it will better facilitate the achievement of the relevant objectives of the Network Code.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Ayesha Uvais on 020-7901-7307.

Yours sincerely,

Paul Smith

Head of Market Surveillance