

OFGEM DECISION LETTER No. 0479
"Incentivised Nomination Scheme"
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Transco, Shippers and other interested parties

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Dear Colleague

Network Code modification proposal 479 "Incentivised Nomination Scheme"

Ofgem has decided to direct Transco to implement Network Code modification proposal 479 "Incentivised Nomination Scheme" (INS). This letter sets out the background to the proposal, the nature of the proposal, respondents' and Transco's views about the proposal, Ofgem's views and Ofgem's decision.

Background

Shippers have an obligation under Standard Condition 3(3) (General Obligations in Respect of Relevant Transporter's Pipe-line System) of the gas shippers' licence not to:

"...knowingly or recklessly act in a manner likely to give a false impression to a relevant transporter as to the amount of gas to be delivered by the licensee on a particular day to that transporter's pipe-line system or as to the amount of gas to be comprised in its offtakes there from on that day."

Shippers have a further obligation under sub-paragraph 4 of this condition to use reasonable endeavours to make arrangements with others, such as terminal operators and other shippers, at each delivery point it uses on Transco's pipe-line system, to secure prompt and accurate information is provided to Transco in respect of that shipper's deliveries of gas each day at the delivery point in question.

Under Section C1.2 of Transco's Network Code, by 13:00 on D-1, shippers must provide Transco with nominations for offtakes at daily metered (DM) sites. By 16:00 on D-1, shippers must provide Transco with nominations for inputs at each entry point. From 17:30 on D-1 until 03:59 on the gas day, shippers can re-nominate for their inputs at each entry point, offtakes at each DM site and for trades at the NBP.

Transco issues forecasts of demand for non-daily metered (NDM) sites in each LDZ for each shipper at 10:00, 13:00, 16:30 and 00:00 for D-0 (within-day), and at 13:00, 16:00 and 00:00 for D-1 (day ahead).

The current gas balancing regime provides shippers with incentives to balance their supply and demand over the gas day. Imbalances between shippers' inputs and offtakes over the gas day are cashed-out. If a shipper does not deliver enough gas onto the system to meet its customers demand, it is 'short' gas, and pays Transco the System Marginal Buy Price (SMP_{buy}) for the gas it is short. SMP_{buy} is set by the higher of: the highest priced Transco buy trade on the gas day; and the System Average

Price (SAP) SAP is the weighted average of the price of all trades on the On-the-Day-Commodity-Market for the gas day, plus a fixed differential of 0.0287 p/kWh, calculated to reflect the cost of storage. If a shipper delivers more gas onto the system than is demanded by its customers, it is 'long' gas, and receives from Transco the System Marginal Sell Price (SMP_{sell}) for the gas it is long. SMP_{sell} is set by the lower of: the lowest priced Transco sell trade on the gas day; and SAP less a fixed differential of 0.0324 p/kWh, calculated to reflect the cost of storage. The costs/ revenues incurred/ received by Transco for cash-out, known as 'neutrality', are redistributed amongst all shippers based on the amount of gas they put through Transco's system.

In February 2001, Ofgem published proposals for further reform of the gas balancing arrangements, following the implementation of the New Gas Trading Arrangements (NGTA) in October 1999. "The new gas trading arrangements, Further reform of the gas balancing regime", Ofgem, February 2001. Transco approached Ofgem in summer 2000 with concerns about how the existing gas balancing regime was operating. In its February 2001 proposals, Ofgem set out its concerns that within-day profiling of gas flows by shippers at entry and exit points could cause Transco to undertake inefficient balancing actions and to experience within-day operational problems, which could threaten security of supply on the gas network. Increased within-day profiling of flows at the gas interconnectors was already evident, and there was the prospect of increased within-day profiling by gas fired electricity generating plant following the introduction of new electricity trading arrangements in March 2001. The exacerbation of operational problems for Transco due to profiling could cause Transco to interrupt gas supply to power stations, which could threaten system security on the electricity network.

Since February 2001, Transco has continued to advise Ofgem that input profiling under the existing daily balancing regime, along with a significant disparity between information provided to Transco by shippers and terminal operators on gas flow intentions and actual flows, is making it difficult for Transco to efficiently balance and operate its system, and could in some circumstances threaten within-day system security on Transco's system.

In February 2002, Ofgem published revised proposals for reform of the gas balancing regime, which took into account respondents' comments on Ofgem's February 2001 proposals. "The New Gas Trading Arrangements, Reform of the gas balancing regime, Revised proposals", Ofgem, February 2002. Ofgem proposed a framework for reform, which has, three main elements:

- shorter balancing periods than one day, to reflect the period within which Transco's system can safely manage profiled flows and to allow more effective targeting through cash-out of the costs incurred by Transco in balancing the system within-day;
- the sale of system linepack, to allow shippers to manage their imbalances across a number of balancing periods; and
- improved commercial incentives, to provide better information to Transco of intended gas flows.

In addition to Network Code modification proposal 479, Transco has raised three other modification proposals to address its concerns about the current gas balancing regime, which could be implemented for winter 2002/3:

- Network Code modification proposal 511 "Removal of NDM Forecast Deviation from Imbalance Calculations" proposed that all shippers imbalances would be cashed out at system marginal prices and no imbalances would be cashed out at SAP. Earlier this month Ofgem directed

Transco to implement this modification proposal, and this modification proposal will be implemented with effect from 1 October 2002;

- Network Code modification proposal 512 “Introduction of a Within-Day Entry Profiling Charge” proposes to charge shippers who ship gas at entry points where there is input profiling any ‘system’ balancing costs incurred by Transco during the day. ‘System’ balancing costs would be those costs incurred as a result of Transco taking actions to address within-day operational problems. This modification proposal is currently being discussed in the Network Code Energy and Capacity workstream; and
- Network Code modification proposal 527 “Introduction of a Within-Day Exit Profiling Charge and an Exit Failure to Notify Charge” proposes to introduce charges for large system offtakes where Transco did not get the notice period specified in the NExA for changes in flow rates and for deviations from flow rates agreed with Transco outside of the NExA provisions. This modification proposal is currently being discussed in the Network Code Energy and Capacity workstream.

As part of the process of achieving a more enduring solution to the problems being experienced, in December 2001, Transco raised Network Code review proposal 513 “Reform of Energy Balancing Regime”. Under this proposal, Network Code review group 513 has been set up to consider how the current gas balancing regime is operating and whether any changes could be made to the existing gas balancing regime to address problems identified with the existing regime. Such changes would be unlikely to be implemented by winter 2002/3. Shippers, customers, offshore producers, interconnector operators and a range of other interested parties have been invited to attend the review group. The review group is required to produce an interim report this month and a final report in August 2002.

Nature of the proposal

Network Code modification proposal 479 proposes that shippers nominated imbalance positions (the difference between shippers physical inputs and offtakes, net of trades) at 02:00 D-1, 12:00 D, 18:00 D and 22:00 D would be compared to their allocated imbalance at the end of the gas day. If there was a difference between a shipper’s nominated imbalance position at the four pre-defined times and a shipper’s end of day allocated imbalance greater than the shipper’s NDM forecast demand deviation tolerance, the shipper would face a charge.

The charge faced by shippers would be based on the difference between the SAP and the system marginal prices. Where a shipper’s nominated imbalance position was greater than its allocated imbalance the charge would be based on the difference between the SAP and the SMP_{sell} . Where a shipper’s nominated imbalance position is lower than its allocated imbalance the charge would be based on the difference between the SAP and the SMP_{buy} . The modification proposes that a scaling factor of 0.25 be applied to these differences to calculate the charge and that the charge be the same for differences between nominated imbalance positions and allocated imbalance at each of the four pre-defined times. The charges would only be applied on those days when Transco took a balancing action.

Any revenue generated from the charges would be smeared back to shippers through the balancing neutrality mechanism.

Respondents’ and Transco’s views

17 responses were received to the proposal. 6 respondents supported the proposal. One of these respondents support for the proposal was conditional on a reduction in the level of the proposed charge. 2 respondents did not express a clear view for or against the proposal. 9 respondents did not support the proposal.

7 respondents broadly accepted Transco's concerns about the deteriorating quality of information it received for balancing the system. One respondent identified the greater commercial freedom available to shippers since the NGTA were introduced from October 1999, and believed that it was appropriate to consider whether these changes were still in the best interests of customers. One shipper stated that it did not accept that a significant problem had been identified and argued that any uncertainties faced by Transco were no different to those faced by shippers. It also stated that if there was a major issue affecting safety that Transco should discuss its safety case with the Health and Safety Executive (HSE). Two respondents noted that the balancing neutrality costs were currently positive, and therefore, questioned the need to implement the proposal.

Transco stated that it had repeatedly explained its concerns about the increasing disparity between the information it receives from different sources to inform its balancing of the system. Transco said that the effect of the NGTA changes could be considered in Network Code review group 513 "Reform of Energy Balancing Regime". Transco did not accept that it faced the same uncertainty as shippers, because it was responsible for the physical balancing of the system, whereas shippers were responsible for balancing their own portfolio. Transco said that its proposal was intended to address concerns about the commercial incentives faced by shippers. It regularly liaised with the HSE regarding its safety case. Transco did not believe that the costs and revenues generated in balancing neutrality necessarily showed that there were not problems of poor quality information leading to inefficient balancing actions.

Eight respondents believed that the modification should not be implemented because it was more appropriate to consider changes to the gas balancing regime through Network Code review group 513, rather than making changes at this time. 3 respondents believed that more consideration needed to be given to the interaction between the proposal and Network Code modification proposals 511 "Removal of NDM Forecast Deviation from Imbalance Calculations", 512 "Introduction of a Within-Day Entry Profiling Charge" and 527 "Introduction of a Within-Day Exit Profiling Charge and an Exit Failure to Notify Charge". 3 respondents stated that they did not support Ofgem's proposals for shorter balancing periods, and said that an incremental approach to reform of the gas balancing regime would be preferable.

Transco believed that a wider review of the gas balancing regime was appropriate through Network Code review group 513. However, it believed that as the system operator it had to consider whether there were changes that could be made in the interim to address its concerns. Transco agreed that incremental reform to the gas balancing regime was the appropriate way to address the problems identified.

Six respondents expressed concerns that the costs of implementing the modification proposal were greater than any benefits that may arise from introducing the proposal. One respondent said that given the relatively low implementation costs of the proposal it should be pursued before other more costly options. Another respondent said it always gave Transco accurate information, so did not expect the proposal to have a significant operational or cost impact.

Transco accepted that without experience of implementing the proposal it was difficult to precisely quantify the benefits of implementing the proposal. However, it believed that it would obtain better information for balancing the system following implementation of the proposal, and would therefore

make more efficient balancing decisions, thereby reducing balancing costs. Transco noted that its implementation costs would be recovered from costs already allowed for in its System Operator incentives.

Three shippers did not believe that the proposal would address the problems identified by Transco of within-day profiling of gas flows.

Transco accepted that its proposal would not directly address its concerns about within-day profiling of gas flows. However, it believed that the proposal would help it make more efficient balancing decisions because it received better information. It also believed that because shippers would be exposed to the costs of changing their end of day imbalance nomination across the gas day, they may seek to reduce the risk of incurring charges under INS by reducing within-day imbalances. It also noted that it had raised Network Code modification proposal 512 to specifically address its concerns about within-day profiling of gas flows at NTS entry points.

Some respondents suggested an alternative range of approaches to address Transco's concerns, including enforcing existing requirements in the gas shippers' licence, Ofgem imposing penalties on shippers that persistently breached Network Exit Agreement (NExA) provisions (similar to provisions that apply in the electricity regime for breaching the Grid Code) and applying a more restrictive balancing regime to those shippers most likely to profile gas flows within-day, e.g. power stations and other large users. One shipper believed that Transco would benefit more from information about the actions shippers are going to take to balance than about end of day imbalance positions. Another shipper suggested that Transco should develop models to assess different shippers likely balancing behaviour.

Transco stated that currently there are limited commercial incentives on shippers to provide it with accurate information and that this proposal will improve those incentives. Transco said that its proposal might also help to identify shippers with a persistently poor performance. Transco had sought to develop models of shippers balancing behaviour, but these had not proven to be sufficiently reliable to improve its decision making process.

One shipper suggested that the INS proposal may lead to Transco receiving less information because shippers will wait longer to make nominations until they understand their projected imbalance position. Two other shippers believed that the additional information might create more confusion for Transco if it differed from information it already receives on AT Link.

As shippers will have to confirm a specific "INS nomination", Transco did not believe that the accuracy of the existing AT Link nominations will be affected. Transco believed that the charges under the INS proposal would help to ensure that shippers will provide accurate information.

Two respondents supported the proposed charging structure. One respondent believed that the proposed charging structure would generate more cost reflective charges and would not undermine incentives to balance under the cash-out regime. One shipper believed that the charge would need to be set at a much higher level than proposed to improve the quality of information provided and that this would undermine the incentives to balance under the cash-out regime. Two respondents believed that the proposed charging structure would undermine the incentives to balance. One respondent believed that the proposed charging structure would lead to charges that were too high, which would increase spot gas prices. It suggested a lower level of charges initially until the effect of the proposal had been reviewed. One shipper believed that only levying a charge on days when Transco takes a balancing action did not reflect changes in linepack levels over the day. One shipper considered that it was unlikely shippers would ever achieve a zero imbalance, so would always incur charges under INS.

Another respondent supported the philosophy that those shippers providing poor quality information should face a charge.

Transco said that it believed that the charge should be dynamic and reflect, as far as possible, the value of within-day flexibility on the system. Transco believed that the proposed charging structure was the best available given the extensive consideration of alternative options in the workstream. It accepted that the charging structure could be reviewed in the light of experience of the operation of INS. Transco believed that the charging structure provided stronger incentives for shippers to achieve an end of day balance at any time before the last time a nomination under INS must be made, and that after that time shippers will be neutral between better achieving an end of day balance or their nominated imbalance position under INS.

Therefore, Transco considered that the proposed charging structure was complementary to the existing incentives on shippers to balance under the cash-out regime. Transco believed that it was important that a charge was not levied under INS if it did not take any balancing actions. It noted that under its System Operator incentives it had an incentive to take balancing actions if the linepack level at the end of the day was projected to differ from the level at the beginning of the day by more than 2.4 mcm. Transco noted that because the revenue generated under the proposal is smeared back to shippers in proportion to their throughput on the system, it will re-distribute money to those shippers providing the best quality information from those providing poor quality information.

Two respondents believed that the proposed times at which shippers would make end of day imbalance nominations under INS were a pragmatic starting point. One respondent believed they were arbitrary.

Transco said that the nomination times under INS were consistent with the times at which NDM demand forecast changes were published by Transco and when Transco systematically reassesses the system balance. Transco said that the nomination times used for the charging structure could be reviewed after INS was implemented.

One respondent did not support the application of the NDM forecast deviation tolerance to charges under INS irrespective of Ofgem's decision regarding Network Code modification proposal 511. Another respondent believed that the tolerance should be removed if Ofgem decided that Network Code modification proposal 511 should be implemented.

Transco said it would consider removing the tolerance from the charges under INS if Ofgem decided to implement Network Code modification proposal 511. Transco said it would ensure that INS was implemented in a way that allowed the tolerance to be easily removed.

Six respondents believed that the proposal might reduce within-day trading because shippers would trade more ahead of the day to avoid the charges under the proposal. Concern was expressed that this may make it particularly difficult for smaller shippers to balance cost effectively. Two respondents believed that the bid offer spread for within-day trades would increase because charges under INS would be factored in to the spread prices.

Transco believed that if within-day trading volumes reduced because the proposal encouraged shippers to enter the day in a more balanced position that should be considered a benefit of the proposal. However, Transco did not believe that the proposal would significantly reduce within-day trading because shippers would still have incentives to balance by the end of the day and to meet the end of day imbalance nominations made under INS, so would trade in response to events within-day, e.g. supply failures. Transco did not believe that there were costs associated with the proposal that would be factored into within-day bid offer price spreads for trades, because shippers changing flows onto the

system to support a trade will not be changing their imbalance position, so will not face any additional costs under the proposal.

Two shippers believed that the proposal would encourage Transco to take fewer, but not necessarily more efficient, balancing actions. One shipper believed that the proposal might confuse which party, shipper or Transco was taking balancing actions. Two shippers believed that the proposal would increase Transco's balancing role. One of these shippers believed that Transco's balancing role would increase because of shippers difficulties in responding to unforeseen problems, e.g. supply failures, under the proposal. The other shipper believed that the proposal would introduce a pseudo-gate closure regime because the charging structure was penal and would reduce shippers within-day trading. One shipper believed that if the proposal was implemented, Transco's System Operator incentives should be reviewed to ensure it did not make excessive returns.

Transco noted that shippers had very different views on the effect of the proposal on its balancing role. Transco stated that under the proposal shippers would still have incentives to respond to unforeseen events because of the cash-out regime and charging structure under INS. Transco believed that the proposal would lead to it taking less inefficient balancing actions because it would have more confidence that shippers would flow gas to meet their nominations. Transco considered that from a system operator perspective there might be benefits in a regime with stronger incentives on shippers to balance. Transco believed that if the proposal did lead to it balancing the system more efficiently this would generate benefits for the whole industry and customers.

Three respondents expressed concerns that the proposal penalises shippers who suffer unforeseen problems within-day, e.g. supply failures.

Transco believed that if shippers suffered supply failures that led to it having to take balancing actions, those costs should be targeted on the shippers causing them to be incurred.

One shipper favoured a 1 October 2002 implementation date to allow shippers time to develop their systems.

Transco stated that subject to Ofgem approval of the proposal by 15 February 2002 it could implement the proposal from 1 September 2002. Transco believed that implementation from 1 September 2002 gave shippers sufficient time to develop their systems.

Ofgem's views

Ofgem has considered whether the proposed modification will better facilitate achieving the relevant objectives of the Network Code under amended Standard Condition 9 of Transco's Gas Transporters licence. In particular, Ofgem has considered whether the proposed modification will better facilitate the economic and efficient operation of Transco's pipe-line system and securing effective competition between relevant shippers and between relevant suppliers. Ofgem has also taken account of the duties of the Gas and Electricity Markets Authority under the Gas Act 1986 (as amended) and all other relevant factors.

Ofgem recognises the difficulties that Transco has faced in making balancing decisions as the quality of the information it receives from shippers and terminal operators has deteriorated. In its February 2002 revised proposals for reform of the gas balancing regime, Ofgem presented evidence of the deterioration in the quality of information provided to Transco. It is therefore appropriate for Transco to consider options, including this modification proposal, to address this problem by improving the commercial incentives for shippers to provide it with better quality information about their intended

behaviour. Where a shipper provides poor quality information to Transco, which leads to Transco having to take balancing actions, as far as possible, these costs should be targeted at the shipper causing them to be incurred. Better cost targeting can be expected, in general, to better facilitate securing effective competition between relevant shippers and between relevant suppliers.

Ofgem has considered the potential effects of this modification proposal, and in particular:

- whether it can be expected to improve the information provided to Transco by shippers and therefore help Transco to make more efficient balancing decisions;
- how it will affect shippers' incentives to balance their supply and demand under the cash-out regime; and
- the possible effect on spot and forward gas prices if this modification proposal was implemented.

In doing so, Ofgem has had regard to, amongst other things, the responses to this consultation.

The proposal may improve the information Transco receives to make balancing decisions, and in particular, could increase the confidence Transco has regarding shippers intended flows of gas towards the end of the gas day. This should reduce the need for Transco to take balancing actions, which are potentially unnecessary, because it currently does not have confidence that shippers will deliver flows in line with their nominations late in the gas day. Such a situation can be expected to better facilitate the economic and efficient operation of Transco's system.

Ofgem recognises that the modification proposal will interact with the commercial incentives on shippers to balance their supply and demand positions. In considering whether to direct that this modification proposal be implemented, Ofgem has had regard to the possible effect on the incentives for shippers to balance against the potential benefits of the modification proposal in providing better information for Transco to make balancing decisions.

Ofgem notes that some respondents are concerned that the modification proposal might increase to some extent the risks faced by shippers because in addition to the cash-out regime for being out of balance, shippers will face the risks of charges under this proposal. These increased risks could feed through into higher spot and forward gas prices. However, it seems likely that given that the modification proposal may improve the efficiency of Transco's balancing actions, this should reduce the risks faced by shippers, which in turn should feed through into lower spot and forward gas prices.

Before making its decision as to whether to direct Transco to implement this proposal, and in recognition of the concerns raised, Ofgem asked Transco to consider whether a process could be put in place to monitor the effectiveness of the proposal if it was introduced. Transco has sent Ofgem the attached letter proposing a process for monitoring the effectiveness of INS if it is implemented. This process would include the provision of monitoring information on a monthly basis, available to all interested parties. Transco has proposed that shippers and interested parties would have the opportunity through the workstream to develop the reporting process in advance of implementing this modification proposal.

Having considered that matter and representations carefully, Ofgem considers that the modification proposal will, on balance, improve the information Transco receives in order to make balancing decisions. On the basis of information available it seems likely that the modification proposal should reduce the need for Transco to take balancing actions, which are potentially unnecessary. As such,

Ofgem considers that this modification proposal will better facilitate the economic and efficient operation of Transco's system.

Therefore, Ofgem has decided to direct Transco to implement this modification proposal.

Ofgem's decision

Ofgem has decided to direct Transco to implement this modification proposal.

Other matters

In relation to the implementation date, while this is matter for Transco, Ofgem notes that respondents wanted sufficient time to develop the necessary systems. While, Ofgem believes it is important that the modification is implemented for winter 2002/3, we would be content for the proposal to be implemented from 1 October 2002 rather than 1 September 2002, to allow shippers sufficient time to develop the necessary systems. Ultimately this decision is for Transco.

It is important that once the proposal is implemented, its effectiveness is carefully monitored. Ofgem therefore welcomes the proposal from Transco in the attached letter to monitor the effectiveness of the proposal. This monitoring process will allow both the overall effectiveness of the proposal, and the effect of specific aspects of the proposal, e.g. the charging structure, to be assessed.

Before the modification proposal is implemented, Ofgem would encourage Transco to consider carefully whether the NDM demand forecast deviation tolerance should still apply to charges under this proposal, following Ofgem's decision to direct Transco to implement Network Code modification proposal 511.

This modification proposal does not address all of the concerns raised by Transco and Ofgem regarding the current operation of the gas balancing regime, and in particular, the activities of shippers within-day, e.g. profiling of gas flows at input and offtake points. Therefore, it is important that Network Code modification proposals 512 and 527 are properly considered in sufficient time to allow potential implementation for this winter if, following industry consultation, Ofgem concludes that they better facilitate the relevant objectives of the Network Code.

Finally, Ofgem continues to believe that it is important that Network Code review group 513 continues to consider the options for addressing the concerns identified with the current gas balancing regime over the longer term.

If you have any questions regarding Ofgem's decision or the issues raised in this letter please contact me or Paul Smith on 020-7901-7374.

Yours sincerely

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