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Transco, Shippers and Other Interested Parties

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Dear Colleague,

Urgent modification proposal 0456 'Exemption from (Mod414) Zero Tolerance /Energy Incentive for Irish UK Interconnector'

Ofgem has carefully considered the issues raised in modification proposal 0456 '*Exemption from (Mod 414) Zero tolerance /Energy incentive for Irish UK interconnector*'. Ofgem has decided to direct Transco not to implement this modification because we do not believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

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

Background to the proposal

Under the Network Code, all shippers are currently allocated a number of imbalance tolerances. These tolerances provide shippers with limited relief from marginal cash-out prices for any imbalances between their gas inputs and offtakes to Transco's National Transmission System (NTS) at the end of each gas day.

Any shipper imbalances within tolerances are cashed-out at a System Average Price (SAP) while imbalances beyond tolerance levels are cashed-out at System Marginal Price (SMP). SAP is calculated on the basis of the weighted average of all gas trades on the On-the-Day Commodity Market (OCM). SMPs are calculated on the basis of the highest (charged for shipper imbalances where the shipper is short at the end of the day) and lowest priced trades (charged for shipper imbalances where the shipper is long at the end of the day) on the OCM on the day.

There are currently three types of tolerance available to shippers, namely Imbalance Tolerance Quantity (ITQ), Absolute Tolerance Quantity (ATQ) and Forecast Deviation Tolerance (FDT). ITQ is defined as a percentage of each shipper's throughput and varies for each shipper depending upon its customer portfolio and its aggregate level of throughput on the system.

In November 1999, Transco raised modification proposal 0373, '*Changes to Shipper Tolerances, Cash-Out and the Introduction of Tolerance Services*'. This modification provided for the complete removal of ITQ imbalance tolerances and the introduction of a commercial tolerance service. This service would enable shippers to purchase tolerances through a price auction, should they wish to do so, as insurance against being exposed to marginal price cash out for any end of day imbalance.

Ofgem approved modification 0373 in February 2000, but continued to express a strong preference for the development of a linepack service to replace tolerances as soon as

feasible. A linepack service would see Transco auctioning NTS linepack, or the actual storage physically available in the pipeline system itself. Tolerances are a commercial product and the aggregate volume of tolerances sold may not, at any particular time, have reflected the actual physical capability of the NTS to accommodate aggregate imbalances in inputs and offtakes at the end of the gas day.

Ofgem agreed to the implementation of a tolerance service from October 2000 as an interim measure in the absence of a full linepack service. The tolerance auctions were planned to begin from September 2000.

Following Ofgem's approval of modification 0373, there have been a series of modifications relating to the introduction of tolerance services.

On 3 July 2000, V-is-on Gas raised modification proposal 411, '*Postponement of Tolerance Auctions*', which proposed the postponement of the auctions for a six month period. Ofgem directed this modification to be implemented 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 were increasingly using tolerances for commercial purposes. As a result, balancing performance was deteriorating, leading to increased smearing of the costs of system imbalances, potentially damaging competition and the efficiency of system balancing. Third, Ofgem had concerns that tolerances could contribute to within-day profiling activity as shippers may be taking significant imbalance 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 address any of the concerns highlighted and may exacerbate some of the problems experienced under the current regime.

On 20 July 2000 Powergen UK plc raised modification proposal 415, '*Phased Reduction in shipper tolerances*'. Modification proposal 415 proposed that ITQs should be reduced by 50% from their current levels with immediate effect and reduced to zero from 1 April 2001. Ofgem accepted this modification on 22 August 2000 for implementation from 1 October 2000.

In reaching its decision Ofgem reiterated its concerns regarding the existing tolerance regime that were outlined in its decision on modification 411. Ofgem indicated that shipper imbalances have increased significantly in the past year and that there was evidence to suggest that some shippers were using tolerances for commercial purposes to avoid trading out imbalances.

Ofgem indicated that a reduction in tolerances would provide sharper incentives on shippers to trade out their imbalances, further reducing the amount of system balancing that Transco needs to undertake. Ofgem also encouraged Transco and shippers to work together towards

the development of a full linepack service to provide shippers with an additional flexibility tool to assist in the management of the risks associated with being exposed to cash-out prices for imbalances. As mentioned previously, a linepack service would, by offering storage physically available on the NTS, be superior in all respects to a tolerance service. In particular a tolerance service could lead to a greater role for Transco in system balancing, to the extent there was any mismatch between the aggregate tolerance quantity sold and actual system linepack.

It is noted that neither Forecast Deviation, nor ATQs were affected by modification 415. However, ATQs are scheduled to end on 31 March 2001 following Ofgem's acceptance of modification proposal 421, '*Temporary Extension of Absolute Tolerance Quantity*', on 12 September 2000.

In January 2001 Ofgem accepted modification 0440 '*Cancellation of the auction of tolerance service*', which proposed that the changes introduced by modification 0373 regarding tolerance auctions due for implementation in (initially September) April 2001 be removed from the Network Code.

In reaching its decision on Modification 0440, Ofgem reiterated its concerns that shipper imbalances and the use of shipper tolerances for commercial purposes had increased significantly over the past year. Further, in its decision letter to modification 0440, Ofgem restated its concerns that tolerances could be contributing to within-day profiling activity as shippers may be taking significant imbalance positions within-day to force Transco into taking balancing actions.

In this context, Ofgem indicated that any retention of tolerances through the implementation of a tolerance service would be likely to sustain the deterioration in shipper balancing behaviour. In addition, Ofgem indicated that the introduction of a tolerance service could further weaken incentives on shippers to balance by the end of the gas day by potentially increasing the aggregate level of tolerances available to the market and/or individual shippers.

In March 2001, Bord Gais Eireann (BGE) raised urgent modification 0458 '*Exemption from modification 414 zero tolerance/ energy incentive for Irish UK interconnector*'. Ofgem accepted this as an urgent modification proposal on 3 March 2001. In essence this proposal provides for Irish shippers to be granted an exemption from the removal of ITQs and ATQs from 1 April 2001 with respect to their offtakes of gas from the NTS at the Moffat UK/Ireland interconnector.

The modification proposal

In its proposal BGE indicates that it is seeking an exemption from the 'zero tolerance' regime that will apply from 1 April 2001. BGE indicated that the Interconnector between Ireland and the UK is administered by an Agency Agreement between Irish and UK shippers. The Agency handles nominations and renominations between shippers in Ireland, Northern Ireland and Great Britain. BGE state that it is not possible for Irish shippers to improve upon the management of offtakes at Moffat and that it is not always possible 'to match perfectly Allocation with nominations'.

BGE state that the Moffat interconnector which runs between Ireland and UK, is different in many ways to any other interconnector due to the dependence on this source of gas by customers in both North and South Ireland, in particular the residential market. BGE state that the implementation of zero tolerances at the Moffat Interconnector does not recognise the variations of offtake within the Irish residential market. In this regard BGE notes the continued presence of the NDM forecast deviation tolerance in the UK beyond 1 April 2001.

BGE indicates that the imposition of 'zero tolerances' would cause Irish shippers to pay additional penal charges for gas from the UK.

BGE also suggests that the establishment of an Operational Balancing Agreement between the Irish transporter and Transco may alleviate some of its concerns.

Respondents' views

The majority of respondents did not support the proposal.

Although a number of the responses received expressed sympathy with BGE, there was also a general consensus that the exemption proposal would, if implemented, discriminate against other system users and shippers. In particular, a number of respondents commented that the Moffat interconnector was no different from any other interconnector or system offtake and that the proposal sought to introduce preferential transportation arrangements that would discriminate against other connected system exit points (CSEPs) and supply points.

A number of respondents commented that this proposal was not only discriminatory against other system users, but also could be inconsistent with the objectives of reforming the gas balancing regime and moving to zero tolerances. In particular, some respondents suggested that the proposal was inconsistent with the objectives of targeting the costs of imbalances on those participants that have caused them. In this regard it was argued that any exemption would result in shippers on the UK mainland incurring extra costs for the failure of other parties to balance gas flows.

One respondent noted that only a small percentage of the domestic market in North and South Ireland is served by the interconnector. This respondent stated that any inability of Irish shippers to meet domestic variations would be augmented by forthcoming storage projects and supplies from the Corrib field in 2003. This respondent indicated that the remainder of the Irish market is generation or process load that can be forecast to the same degree of accuracy as in the UK. In addition, the respondent stated that flows on the interconnector can be accurately controlled and that imbalances between nomination and delivery at Moffat rarely exceed 1%. In this context the respondent indicated that any exemption from zero tolerances would present arbitrage opportunities between the two connected systems.

Another respondent noted that the transportation company for the UK-Ireland interconnector should use its own linepack to support its end users. This respondent also argued that any errors in matching allocations with nominations on the interconnector fall within the agreement shippers have with the Moffat Agency.

Several respondents noted that if this proposal were accepted, then other interconnectors and offtake points would seek similar exemptions.

One respondent, the proposer, reiterated its support for the proposal and indicated that the establishment of an Operational Balancing Agreement between the Irish transporter and Transco would represent an alternative mechanism to address the concerns regarding the introduction of a 'zero tolerance' regime.

Transco's view

In its Modification Report, Transco indicate that the proposal conflicts with its objectives in that it proposes transportation arrangements that are viewed as preferential. In particular, Transco indicates that the application of a 'zero tolerance' exemption for any CSEP or exit point, would be discriminatory to other system users and may lead to the inefficient and uneconomic operation of the pipeline system.

Transco also states that the forecast deviation tolerance is only relevant to domestic supply points within the UK and that it would be inappropriate to attribute a forecast deviation to Moffat based on Irish NDM end users.

Transco does not support the establishment of an Operational Balancing Agreement. It indicates that there are no other instances within the mainland UK transportation system where an exit point has such arrangements and that such an option would be discriminatory in nature.

Ofgem's view

Ofgem agrees with the majority of respondents that the implementation of this modification would be discriminatory and favour shippers using the Moffatt interconnector when compared to shippers using other similar offtake points (including the Belgium/Zeebrugge interconnector). Shippers using other offtake points are not offered any relief from imbalance tolerances. Transco has a duty under Standard Condition 11 of its Gas Transporter's licence to conduct a transportation business which provides no unfair advantage to any particular users.

Further, Ofgem considers that any implementation of this proposal may be inconsistent with the principle of European law that those operating gas transit grids do not discriminate between undertakings as regards to rights or obligations.

Ofgem has consistently repeated its concerns regarding the existing tolerance arrangements in a number of recent modification decision letters. Ofgem considers that the retention of ITQs and ATQs would detract from the principle of targeting the costs of imbalances on those shippers that cause them. Further, the provision of exemptions to particular shippers from the removal of ITQs and ATQs may offer an unfair commercial advantage to these shippers. In this context, Ofgem considers that granting exemptions to particular shippers and offtake points could lead to an effective cross-subsidy between shippers as other shippers would be required to bear the costs of the imbalances of the exempt shipper(s). This would be likely to distort competition. In this context Ofgem notes that the Authority has a duty, in section 4AA(1) of the Gas Act 1986, to promote effective competition between persons engaged in shipping and transportation. The implementation of this modification is inconsistent with this duty.

BGE in their proposal make particular reference to the uncertainties associated with managing the offtakes of the Irish domestic market. Ofgem recognises that the NDM

forecast deviation tolerance for the UK market will continue to apply from 1 April 2001. However, Ofgem does not consider that this justifies the approval of this proposal. In particular, Ofgem considers that any uncertainties associated with the management of domestic offtakes should be addressed through the use of available flexibility tools or, if deemed necessary, through the introduction of tolerance mechanisms within the Irish gas transportation regulatory framework. Ofgem does not believe it is appropriate for the UK tolerance regime to be used as a mechanism to manage the risks associated with Irish residential loads.

Ofgem's decision

Ofgem considers that, were it to approve this modification, it would be acting in a manner that is inconsistent with its duties under section 4AA(1) of the Gas Act 1986 to promote effective competition between persons engaged in shipping and transportation. In addition, Ofgem notes that Transco are under a licence obligation to conduct a transportation business which provides no unfair advantage to any particular users. To consent to this modification would mean a departure from this obligation.

Further, Ofgem has also assessed whether the modification would better facilitate the relevant objectives outlined under Standard Condition 7 of the Gas Transporter's licence. In this regard, Ofgem considers that the discriminatory nature of this proposal would detract from the objective of securing effective competition between relevant shippers. In addition, granting certain shippers an exemption from the removal of ITQs and ATQs may have a detrimental impact on balancing performance which would detract from the objective of facilitating the efficient and economic operation of the pipeline system. Finally, this modification would also have a detrimental impact on the securing of effective competition between relevant shippers and relevant suppliers by potentially reducing the need for shippers at the Moffat interconnector to trade out their imbalances.

Ofgem has therefore decided not to consent to this modification because we do not believe that it better facilitates the relevant objectives outlined under Standard Condition 7 of the Gas Transporter's licence.

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

Yours sincerely

Steve Smith
Director, Trading Arrangements