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Transco, Shippers and Other Interested Parties

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Dear Colleague,

Modification Proposal 0457 'Cancellation of the auction of tolerance service'

Ofgem has considered the issues raised in modification proposal 0457 '*Operational Linepack Service*'. Ofgem has decided to direct Transco not to implement the modification, because we believe that this proposal does not 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.

As part of the introduction of the first phase of the New Gas Trading Arrangements in October 1999, Ofgem gave consent to modification 313 '*Development of the Energy Balancing Regime to facilitate implementation of the on-the-day commodity market*' that provided for a reduction in existing ITQ tolerance levels of 25%. Ofgem's had always made clear its intention to remove all imbalance tolerances but was persuaded of the need for a phased reduction in tolerances to zero. Ofgem always made clear its preference for tolerances to be removed and replaced with a linepack service based on the ability of the NTS to physically accommodate imbalances through storage capacity in the pipeline system itself.

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 that 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 2000) 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 summary, shippers ITQ and ATQ tolerances are scheduled to end on 1 April 2001.

Ofgem continues to advocate the introduction of a commercial linepack service, most recently in its February 2001 *New Gas Trading Arrangements: Further reform of the gas balancing regime* document.

The modification proposal

Modification 457 proposes that shippers be allocated a volume of linepack each day set equal to a percentage of the shipper's throughput, subject to a minimum and maximum level. The minimum level of tolerance would be set at a level reflecting the minimum trade size on the OCM while the maximum daily linepack service would be set at 2.5 times this level. Shipper daily imbalances held within the linepack level would not be cashed out but carried over to a subsequent day. Imbalances outside of linepack holdings would be cashed out at the relevant system marginal price.

Respondents' Views

Nine respondents commented on this proposal with six expressing support and three expressing opposition.

The common theme that emerged from the respondents that expressed support was that relatively shippers cannot effectively manage the risks associated with small volumes of imbalances and that this proposal would protect shippers from this commercial risk that is

outside of their control. It was further argued that other changes that are to be introduced on 1 April 2001 would expose shippers to penal pricing for these relatively small imbalances. This proposal would then provide necessary protection to manage these small imbalances.

The common theme that emerged from respondents that were opposed was that the proposal was a reintroduction of administered tolerance by another name. The respondents opposing the proposal highlighted the similarity between this proposal and the ATQ regime that is disappearing on 1 April 2001. It was argued that the proposal is inconsistent with recent policy decisions that have sought to tighten up the incentives on shippers to balance their positions at the end of the gas day.

Transco's views

Transco was also opposed to the introduction of the proposal on the basis of the seeming inconsistency with recent policy decisions. In addition, Transco argued that the operational linepack service could not be supported by system changes for implementation 1 April 2001. Transco argued that the proposed tolerance ranges are very small and that the administrative complexities involved would far outweigh any potential benefit to shippers.

Ofgem's View

In its July 2000 review of the New Gas Trading Arrangements and in recent modification decisions Ofgem has outlined its concerns that both shipper imbalances and the use of shipper tolerances have increased significantly in the past year. In particular, we have frequently indicated that shippers have been using imbalance tolerances for commercial purposes to avoid trading out imbalances to the market. We have also frequently outlined our concerns that tolerances are encouraging shippers to take end of day imbalance positions. This may also be contributing to within-day profiling activity as shippers seek to vary within-day positions to force Transco to take a balancing action and influence the end of day cash out price. These concerns have led to Ofgem's decision with regard to Modification 0415 that removed shippers ITQs and to Modification 0421 that did not extend the provision of ATQs.

Ofgem recognises that the decision to cancel the tolerance service will require shippers to access flexibility from the market from 1 April 2000 to manage their imbalance risks given the reduction of both ITQ and ATQ (other than Forecast Deviation tolerance) to zero from this date. Whilst Ofgem recognises that this may create additional costs for some shippers, Ofgem believes that these costs are substantially outweighed by the likely costs associated with the continued presence of tolerances in the gas balancing regime. Reduced shipper balancing performance can lead to a higher number of Transco balancing actions, higher smeared balancing costs and may lead to cash-out prices having a disproportionate effect and/or spilling over in to wholesale gas market prices.

Ofgem does, however, recognise that there are a number of merits in this proposal. In particular, Ofgem supports the proposal insofar as it incorporates the concept of a linepack inventory that can be carried over between days and used as a tool to manage imbalances. The concept of introducing a linepack inventory is consistent with the proposals advocated by Ofgem for introducing a linepack service as part of the further reform of the gas balancing arrangements as outlined in Ofgem's recent February 2001 consultation document, '*The new gas trading arrangements: Further reform of the gas balancing regime*'. Ofgem also notes in this context that the proposal, by introducing an inventory, is seeking to move the gas balancing regime away from a reliance on tolerances and the cashing out of imbalances at system average prices. Ofgem has consistently made clear its views that the presence of tolerances detracts from shipper balancing performance and the objective of efficiently targeting the cost of imbalances on those who cause these costs. By introducing an inventory, the proposal avoids the inefficiencies associated with the tolerance regime and at

the same time retains incentives on shippers to manage imbalances with the flexibility to carry some imbalances over into the next balancing period.

However, Ofgem considers that one of the weaknesses of the proposal is that the linepack allocation is very small and is allocated rather than sold to shippers on the basis of willingness to pay. By allocating the levels of “operational linepack” to shippers according to throughput, shippers will be given this flexibility regardless of the need or value they place on that flexibility. Ofgem believes that this is unlikely to result in an efficient allocation of short-term flexibility amongst shippers and may lead to distortions in competition between shippers.

Ofgem also acknowledges Transco’s concerns that the systems complexity of administering a daily “linepack” service, where imbalances are carried over day-on-day, is likely to be significant. Given Ofgem’s concerns with the other aspects of this proposal, Ofgem believes such complex settlement arrangements are not desirable and that it is more appropriate for the industry to focus its attention on the introduction of a full linepack service.

Ofgem would therefore continue to encourage Transco and shippers to work towards the development of a full linepack service and agrees with the views expressed by many respondents to this effect.

Ofgem’s decision

Ofgem has decided not to give consent to this modification as we do not believe that it better facilitates the relevant objectives outlined under Standard Condition 7 of the Public Gas Transporters’ licences. In particular, Ofgem does not believe that it will facilitate the efficient and economic operation of the pipeline system because of the administrative and IT system costs associated with the proposal given the limited nature of the service. Ofgem also does not believe that this proposal will better facilitate the securing of effective competition between relevant shippers and suppliers as the proposal does not allocate the relevant linepack quantity on an efficient basis. In particular, by allocating the relevant linepack quantity on the basis of throughput (albeit subject to some caps and collars), the modification may create some distortions in trading between shippers and therefore may detract from the objective of securing effective competition between relevant shippers and relevant suppliers.

If you have any queries in relation to the issues raised in this letter, please feel free to contact either myself or Mark Feather (020 7901 7437).

Yours sincerely,

Steve Smith
Director, Trading Arrangements