



Transco, Shippers and all Interested Parties

Direct Dial: 0171 828 0898

10 March 1999

Your Ref:

Our Ref: mod305/245

Dear Colleague,

**Modification 245 – Remove Barriers to On-the-day Trading, and
Modification 305 –
Removal of Requirement to Match Input and Output Renominations for a Trial Period**

Ofgas has made the decision to implement modification 305, with a start date for the trial of 15 March 1999. The trial will continue for a period of 30 days with Transco reporting on behaviour of market participants by 28 April 1999.

In this letter, we set out the background of the network code rules that led to both proposals, the licence obligations on shippers and Transco as well as our reasons for making this decision. Ofgas believes that certain safeguards are required to ensure that some undesirable forms of business conduct do not distort the market during the period of the trial. We welcome comments on the proposed safeguards, as detailed in this letter.

Background

In May 1997, Enron raised modification proposal 149, which would have allowed shippers to make matched renominations at the National Balancing Point (NBP). Transco raised modification 169 as a counter proposal and this was subsequently introduced. Modification 169 allows within-day trading at the NBP accompanied by input and offtake renominations that must meet certain conditions:

- trading chains can only be two shippers in length;
- the matched renominations principle must be preserved across these two shippers; and
- trades are limited to 12 per originating shipper.

These conditions are designed to ensure that shippers do not change their balances within-day in such a way that creates additional balancing actions that might increase system costs.

On D-1, a shipper will post a 'best endeavours' nomination on AT-Link, which represents the shipper's best estimate of its gas flows for the following day. If a shipper renominates within day at an entry or exit point, it must make a matching physical renomination elsewhere such that there is no net effect on its overall physical flow imbalance position. This principle also applies to NBP trades made under Mod 169 during the day, where each counterparty must submit a physical flow nomination to match the other.

The matching renomination rule is seen by some as a significant barrier to liquidity. It is also argued that this rule artificially restricts the way in which shippers are able to inform Transco of changes to their flows during the day. The rule is believed to degrade the information provided to Transco and to exacerbate the continuing discrepancies in the flow data that Transco receives from shippers via AT-Link nominations and the Terminal Operators via Daily Flow Notifications (DFNs).

The conditions imposed on modification 169 trades restrict the liquidity of the within-day NBP market. Removing the matching renomination rule would allow Transco to receive more accurate NBP nominations both on the input side (to improve information on gas flows into the system) and on the output side in respect of DM nominations (thereby improving the accuracy of Non Daily Metered (NDM) nominations).

In July 1998, Enron (with the backing of a number of shippers) proposed a package of modification proposals that included modification 245, 'Remove Constraints from On-the-day Trading'. Arguments against relaxation of the matching renomination discussed at the time were:

- legitimising over- and under-delivery may increase its incidence;
- players may create long or short positions that destabilise the system and create balancing actions;
- shippers may withhold information on nominations until 03:59.

Each of these arguments was considered in detail and it was concluded that:

- the commercial driver for over- and under-delivery is the differential between cash-out and spot prices and that its proposal will not affect this;
- where a player has created a long or short position that destabilises the system and creates balancing actions, that would be a clear breach of Standard Condition 2 of the Gas Shipper's Licence; and
- shippers can withhold information until late in the gas day, yet this does not happen.

In December 1998, Scottish Hydro-Electric put forward modification proposal 305, 'Removal of Requirement to Match Input and Output Renominations for a Trial Period'. This followed discussions in the BC99 workshops convened by Transco. Similar arguments to those listed

above were raised but Ofgas considers, after discussion with Transco and shippers, that the above conclusions are justifiable.

Transco's final modification reports for proposals 245 and 305 include a summary of the representations that were made by interested parties. One shipper has expressed concern that there will be a deterioration in behaviour as a result of the trial. Ofgas has considered the arguments put forward by all shippers and believes that a number of safeguards should be implemented alongside the trial.

Obligations on Shippers

Ofgas would remind shippers that Standard Condition 2 of the Gas Shipper's Licence sets out the general obligation in respect of use of the relevant transporter's pipeline system. In particular, Standard Condition 2(2) requires that:

The licensee shall not knowingly or recklessly pursue any course of conduct (either alone or with some other person) which is likely to prejudice:

- (a) the safe and efficient operation, from day to day, by a relevant transporter of its pipeline system;
- (b) the efficient balancing by that transporter of its system, or
- (c) the due functioning of the arrangements provided for in its network code;

whilst Standard Condition 2(3) requires that:

the licensee shall not 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 pipeline system or as to the amount of gas to be comprised in its offtakes therefrom on that day.

Obligations on Transco

Transco can recommend changes to its network code, under Standard Condition 7(10) of the PGT Licence, if the modification proposal 'better facilitates the achievement of the relevant objectives'. Transco has recommended the implementation of modification proposal 305 because it believes that it will do this for a number of reasons, by:

- facilitating the provision of real-time information from shippers to Transco via AT-Link renominations, by permitting shippers to make non-matching renominations within-day;
- aligning Daily Flow Notifications (DFNs) more closely with AT-Link nominations;

- enhancing Transco's ability to make appropriate operational decisions, thus reducing the likelihood of unnecessary system balancing action being taken by Transco and ensuing smeared costs;
- improving individual shipper risk management and reducing the associated costs of individual shipper balancing by enhancing the ability to trade at the NBP;
- reducing shipper's risk of incurring unnecessary scheduling charges due to the inability to renominate on the basis of changes in portfolio position within-day;
- facilitating the development of a liquid, within-day, gas commodity market;
- establishing whether a permanent change to the network code is required; and
- demonstrating whether the relaxation of the matching renomination rules has meant that Transco has taken inefficient balancing action decisions during the trial and that system balancing costs have increased.

Ofgas' Decision

Ofgas has considered the final modification reports submitted by Transco for the two modifications listed above. We have also met with interested parties to discuss the proposals and the merits of introducing a trial.

Transco, in its reports for both modifications, believes that the two proposals, whilst they differ in detail, are the same in practice. (Modification proposal 245 is a permanent change whilst proposal 305 is a trial and hence a change to the transition document). Enron has accepted this after due consideration of the two proposals. Concern has been expressed by some parties about the potential for gaming and the continuing problem of reducing nominations at the end of day (EOD) to avoid scheduling charges, which is clearly inconsistent with the licence obligations.

Ofgas has decided to take no action on modification proposal 245 at this time but to approve modification 305. The trial will take place for a period of 30 days beginning on 15 March 1999. This period is a 'shoulder' month when weather temperatures can vary significantly. Setting a condition for the suspension of the trial that is linked to balancing activity and/or balancing costs, which is one suggestion that has been raised does not seem appropriate for this reason. Transco has suggested that shippers concerned with the potential for increased costs should raise an urgent modification but Ofgas believes that the safeguards we propose should be sufficient to allay fears that costs will rise as a result of the trial.

Transco has responsibility for the security of the NTS system and, in the event that the trial prejudices its ability to maintain an operational balance, Transco may, by submitting an Active Notification Communication, suspend the trial with effect from the day following that notice. Ofgas believes that, subject to the safe operation of the system, any such decision by Transco to

suspend the trial should be made after consultation with us. We do not believe that this decision should be made by Transco solely for commercial reasons.

Proposed Safeguards

Ofgas has noted the concern of some shippers that undesirable forms of business behaviour during the trial may distort the market and believes that a number of measures should be put in place to monitor the conduct of market participants. Such measures will include:

- Transco will report to Ofgas when DFNs and AT-Link nominations differ significantly and this causes Transco to take a balancing action;
- Transco will notify Ofgas of instances when nominations change significantly between the hours of 00.00 and 04.00;
- Transco will notify Ofgas if there are significant changes in DFNs or AT-Link nominations at any time during the day;
- Transco will keep Ofgas and shippers regularly informed of activity in the flexibility mechanism; and

Ofgas is also exploring options that will allow Transco to suspend individual shippers from the trial in the event of unacceptable behaviour.

Transco has set out the criteria by which the success of the trial will be judged in its final modification report. Ofgas will meet with Transco to discuss the criteria in more detail as well as ways in which the safeguards can be implemented.

Where it appears that a shipper is in breach of its licence, Ofgas will consider taking swift enforcement action, under section 28 of the Gas Act 1986, in line with our statutory obligations.

If you have any questions or comments on this letter, please do not hesitate to contact me on the number given above or Rebecca Purves on 0171 932 1645.

Yours sincerely



Stephen Smith
Director, Gas Trading Arrangements