MODIFICATION PROPOSAL No. 0440

Short Title: Cancellation of the auction of tolerance service

Date: 28 November 2000

Proposed implementation date: as soon as possible, no later than 31 March 2001

Status: Urgent.

Consequence of not making this change:

If this Modification is not implemented shippers will participate in an auction for a tolerance service that will involve substantial costs, and only provides an interim service for risk management until such time as a linepack service is implemented. The auction of the tolerance service risks creating additional distortions in the market, that impact the efficiency of the system, making it more difficult for Ofgem to monitor and regulate the market (at a time when they are undertaking several investigations into shipper behaviour). The industry would also face costs from the introduction of a tolerance service and resources could be removed from important tasks like reviewing the OCM's operation.

Without this modification the gas industry will push ahead with the introduction of a "second best" service that does not fulfil Transco's relevant objectives and could significantly reduce the level of competition, while potentially increasing costs to customers.

Area Of Network Code Concerned:

The changes from modification 373 regarding tolerance auctions due for implementation in April 2001 would be removed from the Code.

Nature of Proposal

This proposal stops the auction of a tolerance service from proceeding. The tolerance auctions may further worsen the physical position of Transco's system in a way that is inconsistent with the relevant objectives. Dynegy believe that there is a need for the community to fully consider the potential impacts of the service, the way it is auctioned and the effect of the revenue recycling that will occur after the auctions. The community can also move towards a linepack service, which seems likely to better facilitate Transco's relevant objectives, without the potential distractions of problems created by the tolerance service.

The modification will also allow further consideration of other changes to the Network Code that may better address the problems that a number of players have identified. For example, the change to the cashout regime may improve balancing incentives and cost targeting to those profiling gas into the system.

Purpose of Proposal

Since modification 373 was implemented, there has been limited consideration of the implications of the operation of the new service, the auction process, revenue recycling and the impact of NETA go live. In light of recent experience, both of the capacity auctions (where 3 shippers secured 66% of capacity at St Fergus), the limited trading of capacity and the operation of the market generally, the tolerance service does not seem consistent with Transco's relevant objectives. By making this

change the risks of creating additional market distortions and possibly adding to the price of delivered gas, a notable concern of the DTI, are removed.

Ofgem should be better able to fulfil its role as regulator if we do not add further complexity to the with-in-day regime. Not only would the tolerance service make it difficult for Ofgem to regulate the market, but it may also provide gaming opportunities for those with very flexible gas production. The legitimising of physical positioning by the end of day, as shippers use the tolerance they purchased, could further influence Transco's balancing actions (a concern Ofgem raised in response to 411), adding to costs, and jeopardise the efficient operation of their network. If Ofgem feels that physical positions should be allowed, if paid for, this will be achieved via a linepack service, which Ofgem has asked Transco to develop.

Dynegy believe the introduction of the tolerance service, as an interim regime to be replaced by a linepack service, is not an efficient use of resources, and contrary to the operation of an efficient and economic regime. This modification allows industry resources to be better deployed securing agreement on a linepack service and examining other measures to improve the efficiency of the gas market. If the service were introduced in April, then shown not to work, the community would be forced to focus on reforming it quickly rather than looking to longer term development of the regime. The Ofgem document on reform of the gas balancing regime, due shortly, should also stimulate debate in this area.

Ofgem registered their concerns about the costs of the tolerance service, both administrative and operational costs, in directing Transco to implement the service from 1 October, and again with modification 411. Ofgem have also continued to express concerns about shippers using balancing tolerances as an alternative to trading out imbalance positions. Dynegy considers that this modification will help mitigate Ofgem's concerns, though we recognise that some shippers are concerned about the risks associated with zero tolerance.

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