Transco, Shippers and Other Interested Parties

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Dear Colleague,

Modification Proposal 0440 'Cancellation of the auction of tolerance service'

Ofgem has considered the issues raised in modification proposal 0440 *'Cancellation of the auction of tolerance service'*. Ofgem has decided to direct Transco to implement the modification, because we 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

Shippers are currently allocated balancing tolerances that provide them with relief from marginal cash-out prices. Any shipper gas imbalances within tolerances are cashed-out at a System Average Price while imbalances beyond tolerance levels are cashed-out at the System Marginal Price.

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

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 reduction of balancing tolerances to zero 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 for their end of day balance position.

The key elements of the original proposal were :

- Two types of service would be made available: Under Delivery tolerance and Over Delivery tolerance;
- Shippers holding tolerance services would gain relief against the relevant SMP exposure;
- Quantities of tolerance services made available will be profiled to reflect the variable proportion that current tolerances make up in total system demand;
- Tolerances will be released via monthly and day-ahead auctions; and
- Tolerances will be tradable.

Modification proposal 373 also recognised that Non daily metered (NDM) Forecast Deviation tolerance would be retained.

In February 2000 Ofgem approved modification proposal 373. In its decision Ofgem indicated it saw merit in having a tolerance service in order to facilitate the efficient allocation of tolerances. However, in reaching the decision Ofgem indicated its preference for the development of a linepack service from October 2000. As such, Ofgem agreed to the implementation of modification proposal 373 from October 2000 on the proviso that it would only be implemented in the absence of a full linepack service. The auctions for tolerances were scheduled to take place in early September 2000.

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 accepted this modification 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 are using tolerances rather than trading out their imbalances in the market. This could keep gas from the market and have an adverse impact on liquidity on the OCM. 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 significantly increase the incentive on shippers to balance.

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 stated that this was inconsistent with the intent behind the tolerance regime to provide limited relief from system marginal cash-out prices in recognition of the uncertainties shippers face in achieving an end of day balanced position.

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 imbalance risks.

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.

The modification proposal

Modification 440 proposes that the changes introduced by modification 0373 regarding tolerance auctions due for implementation in April 2001 would be removed from the Network Code. The legal text is currently identified as for 'Future Implementation'. Modification 411 would therefore be nullified. However the effects of modification 415 would remain.

Respondents' Views

Of the thirteen views received, nine respondents supported the cancellation of the tolerance service. Four respondents opposed the proposal.

In supporting the proposal several respondents indicated that the cancellation of the tolerance service will improve shipper balancing incentives and reduce the potential for market distortions. Some shippers also indicated that the presence of a tolerance service may further weaken shipper balancing incentives by increasing the useable tolerance available to the market. One shipper indicated that the tolerance service may lead to a greater likelihood of within-day profiling behaviour. Another indicated that the tolerance service would create difficulties for Transco in its system balancing role.

A number of shippers commented that the cancellation of tolerance auctions would allow the industry more time to consider the issues surrounding the development of linepack. Further, one respondent suggested that this modification proposal would give the industry an opportunity to assess the implications of operating on zero tolerance, prior to the introduction of a linepack service.

Some shippers commented upon the impact of a combined cancellation of the tolerance service and the reduction of ITQs to zero. Several indicated that whilst it is not possible for shippers to achieve a zero balance there are tools available to allow shippers to manage imbalance risk and SMP exposure.

A large number of respondents supported the proposed cancellation of tolerance auctions because they considered that the service would lead to increased costs to the industry for only an interim period and would add a layer of complexity to the existing regime.

Some respondents indicated that resources should be deployed towards the development of a linepack service with one shipper indicating that the combined cancellation of the tolerance service and zero tolerances would create the necessary incentive for the development of a longer term linepack service.

One respondent qualified its support for the proposal indicating it was subject to a postponement of any further reduction in balancing tolerances. Another respondent emphasised the uncertainties associated with shipper balancing and suggested that the cancellation of tolerance services when combined with zero balancing tolerances would inappropriately reduce the level of flexibility available to shippers. This respondent therefore

suggested that further changes were required to ensure that tolerances remain available to shippers at least until a linepack service is developed.

Of the four respondents that were against the proposed cancellation some argued that the absence of any tolerance service would significantly increase balancing risk when coupled with the introduction of a zero tolerance regime. Two respondents argued that the combined effect of the cancellation of the tolerance service and the introduction of a zero tolerance regime could disadvantage smaller shippers.

One of these respondents indicated that it was premature to remove the tolerance service as it was not clear that existing flexibility tools represent a preferred option for managing imbalance risk. This respondent indicated that it would be difficult to fully evaluate the relative costs of different flexibility products in the absence of a tolerance service and that the tolerance service should therefore be retained.

Overall however most respondents saw merit in the cancellation of tolerance auctions and the introduction of zero tolerance in April 2001, preceding the development of a full linepack service. There was a clear indication that the majority of respondents saw this modification proposal as a move in the right direction.

Ofgem's View

In Ofgem's July 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. As we indicated in our decision on modification 415, we believe that this is inconsistent with the intent behind the tolerance regime to provide limited relief from cash-out prices in recognition of balancing uncertainties.

We have also frequently outlined our concerns that tolerances are encouraging shippers to take end of day imbalance positions and contributing to within-day profiling activity. In particular, in our decision on modification 415 we indicated that on days where Transco takes a system buy balancing action early in the day that effectively sets System Average Price (SAP), shippers may have an incentive to maintain an end of day imbalance position within tolerance levels and be cashed out. If shippers trade out the imbalance at any lower price in the market this would effectively reduce SAP. Ofgem also believes that the existing tolerance regime may be encouraging shippers to influence Transco's balancing actions by sending the system short early in the day to force Transco into a balancing action that sets a higher SAP. Shipper then take advantage of the higher SAP by delivering long into their tolerances.

Our views on the impact of the tolerance regime have also been reinforced by our analysis of the 50% reduction in ITQ from 1 October 2000 which has indicated some improvement in balancing performance since the reduction was implemented. Whilst this analysis has been undertaken over a brief timescale we have found that average aggregate imbalances decreased during October 2000 by 8% for long imbalances (inputs greater than offtakes) and 25% for short imbalances (offtakes greater than inputs), compared to September 2000. Whilst Ofgem recognises that this analysis was undertaken over a limited time period and that there may be other factors influencing the results, we believe it provides some support

for a move towards reducing or eliminating tolerances, in order to improve balancing performance.

In summary Ofgem believes that since its approval of modification 373 in February 2000 there has been a significant change of circumstances surrounding the use of tolerances in the gas market. It is also Ofgem's view that any retention of tolerances through the implementation of a tolerance service would be likely to sustain the deterioration in shipper balancing behaviour that has been experienced over the past year. In addition, it is Ofgem's view that the introduction of a tolerance service may further weaken shipper balancing incentives by potentially increasing the useable tolerance available to the market.

Ofgem recognises that any decision to cancel the tolerance service will effectively 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. These costs include reduced shipper balancing performance, reduced OCM liquidity and gas price volatility.

In this context Ofgem is also not convinced by arguments put forward by some respondents that there is or will be insufficient flexibility available in the market for shippers to manage imbalance positions and address balancing uncertainties in the absence of a linepack service. In particular, Ofgem believes that shippers can trade out the bulk of their imbalances and manage imbalance risk through trading gas or storage products.

However, Ofgem would also continue to encourage Transco and shippers to work towards the development of a full linepack service and agrees with the views expressed by respondents that resources should be spent on encouraging the development of such a service, as opposed to the introduction of a tolerance service.

Ofgem's decision

Ofgem has decided to consent to this modification as we believe that it better facilitates the relevant objectives outlined under Standard Condition 7 of the Public Gas Transporters' licences. In particular, Ofgem believes that this proposal better facilitates the efficient and economic operation of the NTS by improving shipper incentives to balance. Ofgem also considers that the modification better facilitates the objective of securing effective competition between relevant shippers and suppliers by encouraging shippers to trade out their imbalances to the market.

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