Our Ref: Net/Cod/Mod/502
Net/Cod/Mod/568
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Transco, Shippers and Other Interested Parties

Dear Colleague

Modification Proposal 502 – 'Changes to Commercial Arrangements in the Event of a Gas Supply Emergency'

and

Modification Proposal 568 – 'Changes to Commercial Arrangements in the Event of a Network Gas Supply Emergency'

Summary

The Office of Gas and Electricity Markets has considered the issues raised in these two modification proposals. We have decided not to direct Transco to implement either modification proposal. We consider that neither proposal appropriately facilitates the relevant objectives of Transco's network code. In this document, we explain the background to the modification proposals, the nature of the proposals and give our reasons for making these decisions.

Introduction

There has been much debate over the past year or two as to whether the current emergency arrangements in the gas industry remain appropriate. This debate has, to a large extent, taken place in the Gas Industry Emergency Committee ('GIEC'). One particular issue raised in that forum has been the cash-out price that should prevail in an emergency. This has resulted in two proposed modifications proposals. Transco put modification proposal 502, 'Changes to Commercial Arrangements in the Event of a Gas Supply Emergency', forward on 14 November 2001. Transco put modification proposal

568, ‘Changes to Commercial Arrangements in the Event of a Network Gas Supply Emergency’ forward on 16 July 2002.

Background

Transco’s Safety Case with the Health and Safety Executive (‘HSE’) details the network risk assessments that Transco would undertake in calculating the likelihood of a network gas supply emergency. These include whether there were insufficient gas supplies available to the NTS or a critical transportation constraint in either the NTS or in a LDZ.

In the event that Transco calculated that an emergency was likely, Transco would, in its role as the Network Emergency Co-ordinator (‘NEC’), invoke the following five-step procedure:

- Stage one: maximise use of linepack, storage and interruption;
- Stage two: suspend the On-the-day Commodity Market (‘OCM’) and instruct shippers, terminal operators and storage operators to co-operate with the NEC;
- Stage three: begin shedding firm load, in an order determined by the Secretary of State for Trade and Industry under the Priority Gas Customer Arrangements;
- Stage four: system isolation, and
- Stage five: restoration of supplies, in reverse order to stage three, again subject to the powers of the Secretary of State.

Once the OCM has been suspended, there needs to be a price at which shippers are cashed out. Under the current provisions of Transco’s network code, the existing dual cash-out price is replaced by a single price. This is calculated as the average of the System Average Price (‘SAP’) for the 30 days immediately preceding the suspension of the OCM (‘30 day SAP’). The rationale for a 30 day SAP cash-out is that this is a “neutral” price which does not expose shippers to excessive windfalls or losses. In any event, any shipper that believes that it has suffered costs over and above this 30 day SAP is able to submit a claim for such costs.

Concerns

The GIEC was set up to consider the existing gas emergency arrangements. There were several aspects of the existing arrangements that they felt merited some consideration. These included -

- The current rules do not differentiate between a supply deficit emergency, i.e. a shortage of gas being delivered into the system, and a transportation failure emergency, i.e. caused by a lack of sufficient transportation capacity;
- A neutral emergency cash-out price does not do enough to encourage gas onto the system prior to the declaration of stage two of an emergency (i.e. when the OCM is suspended);
- A neutral emergency cash-out price does not encourage customers to reduce gas demand. There are two aspects to this point. First, firm customers will, when the price of gas is high enough, cease consumption, and share the benefits of that with shippers. Second, although shippers to larger firm customers are required to have arrangements in place in order to ensure that they can cease consumption in an emergency situation, tests have revealed that this information is in a poor state;
- Perverse incentives may be given to large shippers who may be able to force the gas system into emergency when the prevailing OCM price is significantly less than a 30 day SAP calculation, and
- Information flows between Transco and the National Grid Company (‘NGC’) could be hindered by information confidentiality provisions.

The proposals to modify Transco’s network code

Following much discussion, the GIEC concluded that a different emergency cash-out regime would address some of these concerns. As a result, modification proposal 502 suggested single cash-out prices dependent on the cause of the emergency: a multiple of 2 times 30 day SAP for a supply failure emergency, and a multiple of 0.75 times 30 day SAP for a transportation failure emergency. Modification proposal 502 also suggested a number of changes that would reduce the number and size of claims for financial loss, and hence the time and effort taken to resolve matters after an emergency.

Modification proposal 568 proposed the same cash-out price as modification proposal 502 but only in the event of a supply failure emergency. It differed from modification proposal 502 in that it suggested that normal commercial arrangements would apply during a transportation constraint emergency and, as a result, there would be no need to calculate a cash-out price.

The overall rationale for the increase in cash-out prices in both proposals was that it would: encourage gas onto the system in the run-up to an emergency; that it would incentivise shippers to put in place arrangements for firm customers to shed their load, and that it would reduce ex-post claims for un-recovered costs.

Respondents' views

Eight respondents expressed a view on modification proposal 502. Of these, there were more in favour of the proposal than against it, albeit that some of that support was qualified.

Transco expressed support for the modification.

Modification proposal 568 also received eight replies. As with modification proposal 502, there were more respondents in favour of the proposal than against it but again, some of this support was qualified. Transco supported implementation of this modification proposal.

The HSE had no view on either modification proposal.

Comparison to the electricity industry

In the electricity industry, there are, to some extent, similar arrangements. The Balancing and Settlement Code ('BSC') explains what happens if the Secretary of State declares an emergency. In these circumstances (after consultation with Ofgem), the Secretary of State may activate changes to the BSC including -

- A single imbalance cash-out price determined to reflect the price of bulk electricity in the relevant settlement period; this price can refer to reported prices and price indices (i.e. the price is intended to reflect the "market price for bulk electricity"); and / or

- Limiting the prices for bids and offers to historic values.

Both of these can be seen as suspending the normal commercial operation of the BSC

The BSC, alongside the Fuel Security Code, also provides for the provision of compensation payments to generators that have suffered exceptional loss in carrying out instructions issued by the Secretary of State. The generators are able, once the Secretary of State has agreed, to recover such costs from suppliers.

Ofgem views

Ofgem welcomes the significant amount of thought that has been put into this issue. However, for the reasons outlined below, we are rejecting both modifications.

First, we are not convinced by the case for increasing the price for cashing out imbalances. We note the conclusion as part of the GIEC discussions that the level of this price would not encourage more gas onto the system once a supply emergency had commenced. Rather, it would be the “command and control” aspects of the NEC that would ensure sufficient gas came onto the system.

As for the run-up to an emergency declaration, it is possible that the expectation of a higher price could encourage more gas to be made available, hence perhaps avoiding the need for an emergency. However, we are not convinced that the prospects for bringing gas onto the system will be materially enhanced by doubling the 30 day SAP (as we have previously explained in our rejection letter for Modification Proposal 294 - ‘*Change to cash-out in an emergency*’). In addition, the prospects for enticing gas onto the system only apply when the 30 day SAP, or a multiple, is higher than the prevailing price in the OCM. This is not always the case.

Second, we do not consider that there has been sufficient work on the interactions between the electricity and gas markets. It seems that an emergency in the gas market would have required in stage one that all interruptible power stations were interrupted. What implications that might have on imbalance prices in the electricity market? Could there be ramifications in the gas market if gas shippers then reacted to these electricity imbalance prices? Some of these questions arise from the fact that the gas market arrangements suspend the operation of commercial markets prior to their suspension in the electricity market arrangements. In addition, consideration needs to be given as to the information flows between Transco and NGC, and to the participants in each industry.

Third, in preparation for winter 2002 /03, Ofgem asked Transco and NGC to consider whether, in their opinion, there are adequate arrangements in place to ensure system security during winter 2002/3. Transco and NGC have now submitted a joint reply. We will be publishing their response, and Ofgem's view on that response, shortly. However, Transco and NGC have not identified cash-out prices in an emergency as being an issue that will impact on the safe operation of the gas system, or the electricity system, for this coming winter. We conclude therefore that it is not imperative that changes are made to the emergency arrangements for this winter for either the gas or electricity industries.

Conclusions and the way forward

We are aware that there has been much work on this subject, some of it possibly prompted by a general feeling that "something must be done". For the reasons outlined above, we are not convinced that modification proposals 502 or 568 are appropriate, in that neither sufficiently meets Transco's relevant objectives.

We believe that any further modification proposal would need to address the following points -

- A detailed consideration of gas / electricity interactions should be carried out. In particular, we would be interested to see some scenarios as to potential imbalance prices in both markets in circumstances leading up to, and including, an emergency situation;
- A detailed consideration of the circumstances that might apply in a transportation supply failure. In particular, we would be interested to see justification as to why Transco, as system operator, should not pick up all costs, including capacity buy-back costs, resulting in such circumstances;
- A consideration as to whether it would be appropriate to keep the OCM running in stage two. As such, this would bring the gas emergency arrangements into line with electricity arrangements (where commercial arrangements continue up

to the intervention of the Secretary of State). This is not to say that the OCM would necessarily replace the "command and control" that the NEC has in place. Rather, the NEC would have the opportunity to rely on the signals generated by the OCM as another way of bringing gas onto, and taking gas off, the system. Normal pricing arrangements would therefore continue to apply during stage two. We are aware that such changes might require a change to Transco's Safety Case, as agreed between Transco and the HSE (as, in a way, this scenario eliminates stage two of the NEC emergency procedure). Nevertheless, some scenarios around the retention of the OCM would be instructive, and

- A consideration as to whether the information flows between NGC and Transco need to be improved.

Decision

Ofgem has decided to reject both modifications because we do not believe that either would better facilitate the relevant objectives of Transco's network code.

While we appreciate the time and effort that has been put in by the gas and electricity industries on this issue, we are not persuaded that the two modification proposals are appropriate. Our view has been particularly informed by the Transco / NGC report. Ofgem remains very interested in any findings of the emergency exercise that Transco will be running this September and looks forward to participating in future discussions on this issue.

This decision letter has been copied to John Wybrew of the Lattice Group plc as chair of the GIEC, the HSE, the DTI and NGC.

Yours sincerely

Kyran P Hanks

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