Comments in respect of Modification 0021: Revision to the Emergency Cashout Arrangements

30 June 2005

The Association of Electricity Producers welcomes the opportunity to comment on this draft modification report.

The Association is not able to support this proposal at this time. We consider there may be some merits in a dual cashout price and the concept of an emergency interruption volume (EIV) trade and that these could be considered to further the relevant objectives. However there are clearly consequences of this proposal which have not been adequately considered in either the proposal or the draft modification report. In particular the wider impacts of a dual cashout price, the lack of clarity on the EIV methodology and processes around this and the absence of any appeal for a short position created by an inaccurate estimate of the emergency interruption volume

The Association has particular concerns over how this proposal has been developed and presented to the industry. Over recent months the Cash Out Review Working Group (CORWG) has been considering the gas emergency cashout arrangements, but last met on 7 March and was suspended awaiting a further timetable in mid April. Then this proposal was issued on an urgent basis in early June. Whilst we accept it is important for there to be clarity over these arrangements in advance of the winter, given that some contractual renegotiation may be necessary, we consider that this proposal should have followed normal procedures and should have been discussed with the CORWG and Transmission workstream before being raised. We also note that the proposal had been sent to Ofgem requesting urgency on 1 June and that it could therefore have been discussed at the Transmission workstream on 2 June, albeit at short notice, but Transco did not request this for. In our view, if there had been discussions with industry players in advance of this proposal being raised then a more robust and better developed modification may have resulted.

Dual Emergency Cashout Prices

The Association accepts that a dual cashout price of this type may place stronger incentives on Users to avoid an emergency situation developing and to minimise the duration of any emergency, particularly when the emergency develops slowly and the market is fully informed of the developing situation. This would be the case in a Gas Deficit Emergency arising as a result of a breach of safety monitors. However it is less clear that a dual cashout price will serve this purpose when a Gas Deficit Emergency arises more rapidly and the market will have a lesser role, if any, in trying to resolve the situation. In such circumstances we should consider the original principles that led to the establishment of the cashout arrangements. These were to ensure that a fair reflective price was paid / received so that parties were not unduly disadvantaged, and that had any party incurred additional costs in bringing extra gas onto the system then they could make a claim to be compensated for these costs. We also note from the minutes of the CORWG[1] 'Most of the group recognised the importance of having a neutral price when the market is effectively "broken"'. Clearly a balance needs to be struck between these principles. It is clear that a key concern is the potential for the interconnector to Europe to reduce imports to the UK and possibly switch to export when an emergency situation is developing in the absence of price incentives to

[1] COWRG Minutes 4 February 2005

maintain imports. However as noted in an Ofgem presentation on gas prices[2] the interconnector was not importing at its maximum rate even when prices were high in the UK at the end of February / early March. Clearly where interconnection with Europe is concerned there are other wider issues that affect interconnector flows that might need different solutions as price alone may not be sufficient until such time as European markets are fully liberalised. It is not clear from this proposal that other options have been explored.

Emergency Interruption Volume Title Trade

The Association broadly supports the principle that this element of the proposal is seeking to introduce; namely, that a User's imbalance position should not benefit from any volumes called for emergency interruption under stage 1 of a Gas Deficit Emergency. We also agree that 30 day SAP would seem to be a reasonable price for the trade, in order to compensate shippers for the revenue they will not receive from the interrupted site. . We also consider that this might lead shippers to interrupt (where they have the rights to do so) earlier than might otherwise have been the case in the absence of this mechanism. This should assist in meeting the objectives above of avoiding escalation of an emergency or minimising its duration, but the consequences of this should also be considered from a consumer and wider energy market perspective, particularly where electricity generation is concerned, such that electricity security of supply could be impacted earlier than necessary.

The Association has some concerns over the methodology for determining the volume attributed to the EIV trade. The methodology as presented by Transco at the Transmission workstream on 15 June at first sight seems reasonable, but it lacking in many areas of detail. As this volume will have commercial implications for Shippers and potentially customers we consider that the methodology should be defined within the UNC itself. This will provide greater clarity and certainty over the process to be used for setting the EIV volume. Any error in the estimate will affect the shipper's imbalance position. In the extreme a gross overestimate of volume for the remainder of the day could leave the Shipper in a short position which will result in exposure to SMP buy prices. Clearly this would be at odds with the aim of this part of the proposal to make the shipper balance neutral to the effects of Emergency Interruption. We also think that further thought needs to be given to the communication processes around the establishment of the EIV for each shipper so that the shipper is aware of the allocated EIV for each offtake, not just its portfolio as soon as possible after the Emergency Interruption has been called.

Given the introduction of the EIV trade it is possible that shippers may find themselves in a short balance position during an emergency, simply due to the volume determination process. Where this occurs we consider that shippers should be able to raise an appeal to cover the cost consequences of the volume error, or alternatively to appeal the volume of the EIV trade itself.

Where the shipper calls interruption before Emergency Interruption is called the shipper will benefit by the released gas becoming part of its balance position or through the sale of this volume. Under normal operation in the past Transco has stated that if necessary it will call Transco interruption at an offtake that is already interrupted by the shipper ('trumping') in order to prevent it from resuming the offtake of gas. Although the methodology issued by Transco [3] notes that the shipper interruption should be netted off the EIV there is no detail as to how this will be done and what assumptions will be made, e.g. what lead time will be applied to emergency interruption and what happens of the emergency persists over a number of days. Similarly further clarity is required in a scenario where a shipper has called interruption with four hours notice, with the expectation that it may trade the gas volume

[2] Ofgem presentation at Demand Side Working Group 6 April 2005

[3] Emergency Interruption volume title trade volume calculation methodology v0.7

released or hold this within its balance position and then within the four hour notice period Transco calls for Emergency Interruption. Clearly in physical terms the offtake must comply with the Emergency Interruption instruction and stop taking gas as soon as possible, but what happens commercially? The shipper may have already sold the gas that it was expecting to be released by the site being interrupted, such that if the EIV trade were to apply it could find itself in a short position.

The Association also seeks clarity on whether it is the intention of the proposal to include emergency interruption volumes and the associated 30 day SAP into cashout prices. If this is the case we would like to see further consideration of the consequences of this, in particular on SMP sell, both in a scenario where the market is suspended and where the emergency situation is relieved following stage 1 actions. In this context we consider that Ofgem's decision letter in respect of BSC modification P172 is relevant since this excludes actions arising from Emergency Instructions relating to system constraints from imbalance prices. This was to ensure that the imbalance prices reflect the costs of managing the supply / demand balance rather than constraints.

Clearly this also indicates a linkage with UNC modification 13/13a that sought to remove Transco's rights to interrupt sites for supply / demand reasons. If this proposal were implemented then it would be legitimate to question whether sites that are interruptible should be interrupted for supply / demand reasons at all, even in an emergency, and whether there is a justification for a different approach in gas from that in electricity that would allow proxy constraint interruption to be included in cashout prices.

In addition, if the UNC modification 13/13a were to be rejected and Transco were to retain the right to interrupt sites for supply / demand reasons at high demand levels we consider that if interruption of this type were called immediately prior to an emergency then in order to have a consistent approach perhaps these volumes should also be included in cashout in some form to ensure cashout prices reflect the supply/demand situation. In this context we are disappointed that Transco has not sought to modify the System Management Principles Statement to provide clarity to the industry that it would use market balancing actions, to the extent that they are suitable, prior to calling interruption for supply / demand reasons. This would then ensure that participants are more fully incentivised to provide demand side response via the market leading to the establishment of cashout prices more reflective of the supply /demand situation.

Specific Questions raised by the SME

1a It is not possible to say whether the dual cashout prices would be set at the appropriate relevant price. It could be said that under some circumstances dual prices might incentivise more appropriate market response but in other circumstances this may not be the case, particularly where the market has insufficient information or limited time to respond. In principle the SMP buy price should reflect the marginal value of demand side response but in practice the price will reflect a whole range of other factors, including risk, costs faced in other markets etc. Delivery of trades in the run up to an emergency and during stage one might also be an issue worthy of further consideration in the context of whether the dual cashout sets appropriate prices.

1b Shippers will face increased risks as a result of SMP buy exposure for short positions during an emergency. Shippers will have limited information on after the day allocations at beach entry points during the day and may find themselves unexpectedly in a short position even though on the day they had acted on the best information available and had taken all reasonable steps to secure gas supplies to their customers. Depending on how the emergency arises some shippers could be materially disadvantaged compared to others through no particular fault of their own, if for example they secure all / most of their gas through one terminal and an incident at that terminal triggered the emergency. Whereas it might be more reasonable to say that shippers are collectively responsible when an emergency develops more slowly, and there is sufficient information available to the market as may be the case when monitor levels are breached.

1c The dual price cashout only enhances the incentives on shippers when there is time for the market to respond and the stages of an emergency proceed sequentially.

2a The methodology above is reasonable but more detail needs to be added concerning the assumptions made and the communications of EIV trade volume. Given the commercial consequences of errors in the EIV volume, the methodology should be in the UNC

2b 30 day average SAP would seem to be a reasonable price to be associated with the EIV trade, but the consequences of including this in the cashout prices needs further thought

2c The risks associated with the EIV trade are discussed more fully above. As the EIV creates further uncertainty on the shipper balance position within day and the possible exposure to the SMP buy price then risks are increased. From a shipper perspective this risk appears almost unmanageable as it has no role in determining the EIV. From a customer perspective the risk will depend on whether any costs are passed on, customers might be able to manage the risk by providing accurate OPNs