Draft Modification Report
Revision of the Emergency Cashout Arrangements
Modification Reference Number 0021

Version 3.0

This Draft Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 9.6.

The procedures agreed with Ofgem for this Proposal are:

As part of the decision letter on Urgency for this Proposal, Ofgem provided the following timetable:

Sent to Ofgem requesting Urgency	01/06/2005
Ofgem grant Urgent status	02/06/2005
DMR issued for consultation	10/06/2005
Closeout for representations (15 working day consultation)	01/07/2005
FMR issued to Joint Office	08/07/2005
Modification Panel Recommendation	13/07/2005
Ofgem decision expected	22/07/2005

The proposer had suggested the following timetable:

Sent to Ofgem requesting Urgency	01/06/05
Ofgem grant Urgent status	02/06/05
Proposal issued to consultation	03/06/05
Closeout for representations (10 day consultation)	16/06/05
FMR due	30/06/05
Ofgem decision	08/07/05
Implementation date	As directed by Ofgem

The SME would particularly welcome views on the following issues

1. In respect of the proposed amendment of Emergency Cash-Out prices from the prevailing single price of the 30 day average SAP to dual prices set at the point of market suspension:
    a. Would the application of the proposed dual Emergency Cash-Out prices be set at the appropriate relevant price?
    b. Does the industry anticipate any increased risks associated with the increased exposure to the prevailing SMP buy price, at market suspension, during an emergency?
    c. Does the introduction of such a mechanism set an appropriate level of incentive that ensures both Users and Transporters take every step through which an emergency may be averted?
2. In respect of the introduction of a new Emergency Interruption Volume title trade and associated ‘trade’ payment:
    a. Clarity on the methodology relating to the calculation of EIV would assist the development of this Proposal and views on this methodology are requested.

b. Is a 30 day average SAP an appropriate 'relevant price' for trading the emergency interruption?

c. Does the industry anticipate any increased risks associated with applying the EIV to the User imbalance? Does the industry anticipate any issues relating to it ability to avoid such risks?

d. Could the Proposer please provide examples of a User Emergency interrupted from a Balanced, Long and Short position.

1. The Modification Proposal

<u>The Proposer stated that the Modification Proposal sought to:</u>

"1. Amend the setting of the Emergency Cash-Out prices from the prevailing single price of the 30 day average SAP to dual prices set at the point of market suspension:

a. Emergency Cash-Out buy price will be set to the prevailing SMP buy; and

b. Emergency Cash-Out sell price will be set to the prevailing SAP.

Concerns relating to the Emergency Cash-Out (gas) processes were raised within the Ofgem Cash-Out Review Working Group (CORWG). CORWG recognised that the creation of the Storage Safety Monitors and the potential for a Monitor Breach to trigger an emergency had made the potential of a Gas Deficit Emergency (GDE) more predictable; by giving the market additional time to respond and create appropriate price signals leading up to the declaration of a GDE. During CORWG discussions it was noted that the current arrangements might not appropriately incentivise Users to take all actions that could be considered prudent prior to the commencement of an emergency.

One of the principle outcomes of CORWG discussions, to date, was the recognition that appropriate incentives were required to encourage Users to take appropriate actions through which a GDE might be avoided, or, its duration or extent reduced. As a result of the ongoing CORWG review, Transco NTS has considered the next steps that could be taken prior to the coming 2005-2006 Winter.

Any change to the GDE Cash-Out price determination should ensure that Users do not have a financial incentive to withhold gas, i.e. the Cash-Out price for "long" Users should be neutral, and ensure that Users have an appropriate financial incentive to offer demand-side response. Transco NTS believes that the Cash-Out price for "short" Users should reflect the marginal value of demand response. A single Cash-Out price cannot reflect both these values and hence dual Cash-Out pricing may be more appropriate.

Rather than being based on the rolling 30 day SAP, Transco NTS believes that the Emergency Cash-Out buy price should be set to the SMP buy price that is prevailing at the commencement of a GDE. Transco NTS believes that the setting of the Emergency Cash-Out buy price on this basis would provide the Users with signals that are better reflective of the actual market conditions immediately prior to a GDE.

The market should be encouraged to deliver and, where appropriate, provide demand-side response, in order to alleviate the extent and duration of the emergency. For example, where Users take long balance positions as a consequence of their actions to maximise beach deliveries or, by responding to emergency demand reduction notices, then these Users should not be financially disadvantaged. Thus Transco NTS considers that the Cash-Out price for a long-balance position should be set at the SAP price at the time immediately prior to the start of the GDE. Transco NTS believes that if implemented, this Proposal would align the Emergency Cash-Out prices to those market prices prevailing at the commencement of a GDE.

2. Introduction of a new Emergency Interruption Volume title trade and associated 'trade' payment

The second element of this Proposal is seeking to assign the volumes of gas associated to GDE interruption actions undertaken by Transco NTS as an effective trade (NBP title transfer) between Transco NTS and the Users. The introduction of an Emergency Interruption Volume (EIV) title trade would ensure that the Users' imbalance positions prevailing at the time of the GDE were maintained.

To ensure transparency and consistency with other Residual System Balancing actions, emergency interruption during a GDE would represent a market balancing action and thus any payment for such actions should be funded from Energy Balancing Neutrality.

In addition to the EIV trade, it is also proposed that for those occurrences of emergency interruption in a GDE, the Users would receive a level of financial recompense based on the EIV volume(s) multiplied by an Emergency Interruption trade price (rolling 30 day average SAP).

The association of a price with EIV trades would result in a payment from Energy Balancing Neutrality to the User of each Interrupted Supply Point. The EIV would be calculated to offset the gas deficit in a GDE and the net imbalance position of all Users should be equal and opposite to the aggregate imbalance of a new Transco NTS 'Emergency Interruption Manager' account. The net effect on Energy Balancing Neutrality would be a payment equal to the net "interrupted" imbalance at SMP buy and a payment out equal to the net "interrupted" imbalance at the Emergency Interruption trade price.Further analysis is required to establish how the EIV would be allocated to individual

Users and Transco NTS intends to provide this during the consultation for this Proposal."

<u>The Proposer stated that:</u>

"Transco NTS is concerned that the current Emergency Cash-out arrangements do not provide the most appropriate incentives on Users to make suitable provision to avoid entering into an emergency situation or, to minimise the extent or duration of such an emergency. This Proposal seeks to provide appropriate incentives on Users in this area.

The Authority has expressed concern in relation to "price sensitive" deliveries to the UK gas market and also questioned whether the current Cash-Out prices during an emergency would provide sufficient incentive to maintain such deliveries.

In order to provide sufficient time for the industry to put in place appropriate arrangements for this coming winter Transco NTS believes that the decision on this Proposal should be provided as a matter of urgency."

Additional Supporting Information

Following the publication of this Proposal, the Proposer, Transco NTS, issued a paper intended to provide additional information which may provide greater clarity in respect of the

‘**Introduction of a new Emergency Interruption Volume title trade and associated ‘trade’ payment’.**

<u>Included in this paper Transco NTS expressed the view that,</u>

“In the event of a potential Gas Deficit Emergency (GDE), Emergency Interruption would be used in an attempt to reach a system supply & demand balance and hence the deficit could be removed. This could result in a scenario where a Shipper, which was short of gas going into an emergency, might be brought into balance through the action of the relevant Transporter calling Emergency Interruption. This might result in limited cost targeting of those Shippers that contributed towards a potential emergency, which might weaken the financial incentive to contract for adequate supplies and demand response. Associating a title trade with emergency interruption would, to some extent, correct this lack of cost targeting. If a trade were associated with the volume of the Emergency Interruption, a Shipper that was short prior to Emergency Interruption would be financially exposed at the SMP buy price to the full extent of its pre-emergency short position. A Shipper that was in balance or long prior to Emergency Interruption would retain this imbalance position after Emergency Interruption.”

In respect of the interruption trade price and payment Transco states that, “Emergency Interruption in a potential GDE would represent a market balancing action and hence it is proposed that any payment for such actions should be funded from energy balancing neutrality.

If Emergency interruption were initiated, a Shipper would no longer receive revenue for gas delivered for that period of interruption from the interrupted sites. Under the prevailing arrangements Emergency Interruption would affect a Shipper’s Imbalance and hence it would receive recompense for any lost revenue at a rate based on the 30 day average SAP; 30-day average SAP has therefore been proposed as the most appropriate level for the Emergency Interruption trade price.”

In its decision letter regarding urgency Ofgem stated that it considered that, “if the modification proposal were to follow non-urgent procedures, there is a risk that, were the modification proposal to be subsequently implemented, there would be insufficient time for the market to properly consider the impacts of the modification and react accordingly, prior to this coming winter.”

2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives

<u>The Proposer stated that:</u>

“That this Proposal, if implemented, would better facilitate the following relevant objective as set out in GT Licence:

In respect of paragraph 1.e): Transco NTS considers that this Proposal might improve, *'the provisions of reasonable and economic incentives for relevant Suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customer'.* The Proposal would ensure that Users continue to be incentivised prior to, and during an emergency, to satisfy their contracted demands.

In respect of paragraph 1.d): Transco NTS anticipates that by targeting cost during an emergency, Users will be encouraged to take appropriate actions through which a GDE might be avoided. Such actions might promote greater and more effective competition between shippers and suppliers."

3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

The Proposer stated that it, "is concerned that the current Emergency Cash-out arrangements do not provide the most appropriate incentives on Users to make suitable provision to avoid entering into an emergency situation or, to minimise the extent or duration of such an emergency. This Proposal seeks to provide appropriate incentives on Users in this area." Views are invited on this aspect of the Proposal.

If implemented, this Proposal would introduce greater commercial incentives, than prevail under current emergency arrangements, for Users to take actions through which entering into an emergency may be avoided, or, its duration or extent reduced. Users responding to such incentives through contracting for greater supply levels, or establishing commercial interruption contracts, may enhance security of supply arrangements.

If implemented, this Proposal may help to avoid the system entering into a Gas Deficit Emergency.

No adverse implications in respect of industry fragmentation have been identified. Views would be welcome if any party believes there would be any such implications.

4. The implications for Transporters and each Transporter of implementing the Modification Proposal , including

a) implications for operation of the System:

In support of this Proposal, the proposer suggested that the "market should be encouraged to deliver and, where appropriate, provide demand-side response, in order to alleviate the extent and duration of the emergency." This alleviation could be considered as a beneficial implication for operation of the System.

1. Setting of Emergency Cash-Out Prices - The proposer did not anticipate any adverse implications in respect of the operation of the system.
2. Introduction of a new Emergency Interruption Volume title trade and associated 'trade' payment - The proposer anticipated that additional manpower would be required to facilitate the operation of Systems, which support this change.

The proposer advised that an impact assessment would follow.

Views would be welcome, from parties, regarding any implications relating to the operation of their respective systems.

b) development and capital cost and operating cost implications:

The proposer has not provided any such cost implications.

A view from the parties would be welcome.

c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

No such cost recovery proposal has been provided by the proposer. Views are invited

d) analysis of the consequences (if any) this proposal would have on price regulation:

Views would be welcome if any party believes there would be any such consequences.

5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

Views would be welcome if any party believes there would be any such consequence.

6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

The proposer stated that:

“1. Setting of Emergency Cash-Out Prices - Transco NTS does not anticipate any significant impact on the UK Link systems.

2. Emergency Interruption Volume title trade and associated trade payment– impact assessment to follow.”

This impact assessment is awaited.

7. The implications of implementing the Modification Proposal for Users, including adiministrative and operational costs and level of contractual risk

If implemented this Proposal may introduce incentives which Users may view as significant enough to require putting in place appropriate arrangements and contracts, prior to the coming winter, through which the risk of incurring potential increases in emergency Cash-Out costs may be mitigated.

Based on the Proposal it is unclear what increases in operational requirements or costs, for User administration of the EIV, will be required.

Views are sought regarding the implications of implementing the Modification Proposal for Users.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

The proposer stated that: “The Authority has expressed concern in relation to 'price sensitive' deliveries to the UK gas market and also questioned whether the current Cash-Out prices during an emergency would provide sufficient incentive to maintain such deliveries.” If implemented this Proposal may require Industry parties to put in place appropriate arrangements and contracts prior to the coming winter.

If implemented, this Proposal may increase the appetite for the industry to enter into commercial interruption arrangements, through which demand side response can be placed on the market. Such arrangements would require negotiation between Users and End consumers.

Views, regarding such implications are invited.

9. Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

Views would be welcome if any party believes there would be any such consequences.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

As part of the 'Supporting Information' in relation to this Proposal, the proposer provided the following views regarding Advantages and Disadvantages.

A**dvantages**

- **The proposer stated: "**Introduces appropriate incentives through which Users are encouraged to make suitable provisions to avoid entering into an emergency situation or, minimize the extent or duration of such an emergency."
- **The proposer stated:** "Provides greater incentives for Shippers and Suppliers to manage their own portfolios and supply obligations."
- **The proposer stated: "**Ensure that the correct responsibilities and liabilities are in place to ensure that demand is managed appropriately, therefore may reduce the risk of a Gas Supply Deficit Emergency (GDE), as defined in the Gas Safety (Management) Regulations 1996.
- **The proposer stated:** "Ensures that Users do not have a financial incentive to withhold gas as a result of the GDE cash-out price determination".
- **The proposer considered that:** Associating a title trade with Emergency Interruption may, 'to some extent', correct the lack of cost targeting experienced under the prevailing UNC Emergency arrangements.

Disadvantages

- **The proposer stated:** "It is recognised that the proposal adds complexity to the commercial arrangements and that the advantages of the proposal can only be successfully delivered if an appropriate proxy for the volume of Interruption aggregated at a Shipper level can be generated. It is our intention to formulate and present a methodology for calculating the Emergency Interruption volume at the 15th June 2005 Transmission Workstream meeting."
- In respect of the EIV, in the absence of methodology for estimating volumes and the impact this may have on a Users Cash-Out imbalance position, it is unclear what the disadvantages may be. It is presumed that the volume applicable is only appropriate if an appropriate estimate were in place.
- This may introduce complexity to the emergency regime which may cause a barrier to competition between Users.

As part of respondents' representations, views relating to perceived advantages and disadvantages of the Proposal would be welcome.

11. Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representations are now sought.

12. The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

Implementation is not required for this purpose.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

Implementation is not required having regard to any such proposed change.

14. Programme for works required as a consequence of implementing the Modification Proposal

The proposer has not provided a program of works.

The SME requests that the proposer provides such a program at the earliest opportunity.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

The Proposer has suggested that this Proposal should be implemented by 1 September 2005.

16. Implications of implementing this Modification Proposal upon existing Code Standards of Service

Views would be welcome if any party believes there would be any such implications.

17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

18. Proposed Draft Legal Text

The proposer has provided the following suggested draft legal text:

1. Setting of Emergency Cash-Out prices:

UNC – TDP section Q 4.2.3.

"For the purposes of this paragraph 4.2 ~~the 'relevant price' is~~:

(a) the "relevant price" In respect of paragraph 4.2.2 (a) is the System Average Price determined under Section F1.2.1 or F1.2.2; and

(b) *the "relevant price" in respect of paragraph 4.2.2 (b) is the System Marginal Buy Price as determined under Section F1.2.1 (a) ~~the Value of the arithmetic mean of the System Average Prices determined under Section F1.2.1 or F1.2.2~~*

In each case ~~but~~ by reference to the ~~30 days preceding the~~ Day on which the Network Code Gas Supply Emergency Gas Deficit Emergency started"

2. <u>Emergency Interruption Volume title trade and associated payment:</u>

UNC – TDP section Q.

Amend paragraph 3.4.5 to read as follows:

"3.4.5 The relevant provisions ………. except that:

(a) ……….;

(b) ……….;

(c) ……….;

(d) ……….

In addition, the provisions of paragraph 6 of this Section Q shall apply following Interruption in a Network Gas Supply Emergency Gas Deficit Emergency, but not otherwise."

Insert the following as new paragraph 6:

"6. EMERGENCY INTERRUPTION

6.1 Definitions

6.1.1 For the purposes of the Code:

*(a) "**Emergency Interruption**" means Interruption due to a Network Gas Supply Emergency Gas Deficit Emergency;*

*(b) "**Emergency Interruption Trade Price**" means the value of the arithmetic mean of the System Average Prices determined under Section F1.2.1 or F1.2.2 but by reference to the 30 Days preceding the Day on which the Network Gas Supply Emergency Gas Deficit Emergency started; and*

*(c) "**Emergency Interruption Volume**" means, in respect of a User, the aggregate volume of gas which Transco NTS reasonably estimates that User would have offtaken from the Total System at System Exit Points in respect of which Emergency Interruption had been called but for the fact that Emergency Interruption had occurred at those System Exit Points.*

6.2 Deemed Market Transaction

6.2.1 On any day in which there is a Network Gas Supply Emergency Gas Deficit Emergency and Emergency Interruption is called at one or more System Exit Points, then:

(a) each User will be deemed to have made a Disposing Trade Nomination, and Transco NTS will make a corresponding Acquiring Trade Nomination for the User's Emergency Interruption Volume;

(b) each User hereby authorises Transco NTS to make such Disposing Trade Nominations as are referred to in paragraph (a) on behalf of the User; and

(c) Transco NTS will pay to each User an amount determined as the User's Emergency Interruption Volume multiplied by the Emergency Interruption Trade Price.

6.2.2 Each transaction which occurs as a result of the operation of paragraph 6.2.1(a) is a Non-physical Market Transaction and shall be deemed to be a Market Balancing Action for the purposes of the Code.

6.2.3 Transco NTS will not pay Balancing Charges, Balancing Neutrality Charges, Scheduling Charges or Daily Imbalance Charges as a result of transactions occurring as a result of the operation of paragraph 6.2.1(a)."

Subject Matter Expert sign off:

I confirm that I have prepared this modification report in accordance with the Modification Rules.

Signature:

Date :

Tim Davis
Chief Executive

Signed for and on behalf of Relevant Gas Transporters:

Signature:

Date :