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The Joint Office, Relevant Gas Transporters and other interested parties

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Dear Colleague

Uniform Network Code modification proposal 035 "Revisions to Section Q to Facilitate the Revised NEC Safety Case"

Ofgem[1] has considered the issues raised in the modification report in respect of modification proposal 035 "Revisions to Section Q to Facilitate the Revised NEC Safety Case", and has decided to direct the relevant gas transporters not to implement modification proposal 035.

On balance, Ofgem considers that it has not been demonstrated that modification proposal 035 will better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11[2] of the relevant gas transporters' licences as compared with the existing provisions of the UNC. In rejecting this proposal, Ofgem understands the arrangements will continue to be in place under the Network Emergency Coordinator (NEC) Safety Case. Ofgem considers that the Safety Monitor arrangements should be urgently reviewed and that revisions to these arrangements, which are capable of implementation for this winter, should to be developed in a transparent manner.

In this letter, Ofgem explains the background to the modification proposal and gives reasons for its decision.

Background to the proposal

In this section we set out a brief background of the recent developments in the gas industry which led to National Grid National Transmission System (NG NTS) raising modification proposal 035.

[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.
[2] This Licence Condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547

Top up

Until October 2004 NG NTS held or placed "top up" gas in store in order to meet any shortfall between its forecast of gas supplies and its forecasts of firm demand for the forthcoming winter under '1 in 50' severe weather conditions.[3]. NG NTS set 'monitor' levels for different categories of storage site, which defined the amount of gas that NG NTS considered would need to be held in store on each day throughout a given winter to ensure that demand in a 1 in 50 winter could be met according to its forecasts. In addition to 'filling' any opening shortfalls (where there is available storage capacity), the top up arrangements required NG NTS to intervene in situations throughout winter where storage stocks would have otherwise fallen below these monitor levels by 'counter-nominating' to keep gas in store. NG NTS actions attempted to prevent gas being withdrawn by shippers from storage so that the volume of gas still in store remained above the monitor level.

Network Code modification proposal 710 "Removal of Top-up arrangements"[4]

Removal of top up arrangements

In May 2004, Ofgem initiated a review of the top up arrangements[5]. This identified the following issues:

- that the top up arrangements had the potential to lead to substantial direct costs to NG NTS and substantial indirect costs to customers through higher prices, when the supply and demand position was tight without any significant improvement in security of supply; and
- that NG NTS's forecast for last winter indicated that because of the tightening of the supply and demand position, the top up monitor levels would be set very high which would be likely to give rise to substantial NG NTS counter-nominations with the prospect of substantial direct and indirect costs being generated by the top up arrangements in 2004/05 without any significant improvement in security of supply.

Following this review, NG NTS, Transco as it then was known, brought forward modification proposal 710, which sought to remove the top up arrangements from Transco's network code, which included the following:

- the storage bookings and winter injection processes; and
- the calculation of storage monitor levels, stored gas requirement and top up market offer prices.

On 18 October 2004, Ofgem approved modification proposal 710, removing the top up arrangements.

[3] Severe winter weather conditions that would only be expected to be experienced once every 50 years.
[4] www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9030_710D.pdf
[5] 'The review of top up arrangements in gas, Consultation document', Ofgem, May 2004 and 'The review of top up arrangements in gas, Conclusions document', Ofgem August 2004.

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Introduction of Safety Monitors

As part of modification proposal 710, the top up arrangements were replaced with the concept of Storage Monitors. There is now an obligation on NG NTS to publish two monitor levels aggregated by storage facility type by 1 October in each gas year in respect of each storage facility. The "Firm Gas Monitor" covers the total firm demand and is published for information only. The "Safety Monitor" covers those sectors of demand defined in NG NTS's Safety Case (including priority firm daily metered customers and non-daily metered customers). The purpose of the Safety Monitor is to ensure safe run down of the system to protect those customers that cannot be protected by isolation and thereby protect public safety in the event of an emergency following a shortfall of gas.

Following the publication of the monitor levels, NG NTS keeps under review the information upon which the monitors have been calculated and has the ability to:

- reallocate the Safety Monitor and/or the Firm Gas Monitor between storage facility types in order to enhance the security provided by current storage stocks;
- reduce a Safety Monitor and/or a Firm Gas Monitor to reflect changes in longer-term demand forecasts; and
- adjust a Safety Monitor and/or Firm Gas Monitor to reflect the occurrence of severe weather.

NG NTS publishes periodic information in relation to each Storage Facility Type, highlighting the risk of a breach of the Safety Monitor, within operational timescales. Where NG NTS is aware that the Safety Monitor levels have been, or are forecasted to be, breached then NG NTS would liaise with the NEC prior to the NEC declaring a Network Gas Supply Emergency (NGSE).

Changes to the NEC Safety Case

Following the introduction of the Safety Monitor arrangements, the Health and Safety Executive (HSE) stated that it wanted these arrangements to be outlined and demonstrated in the NEC Safety Case. NG NTS considered that in a Safety Monitor Breach emergency, it would be inappropriate to allow gas to continue to flow from the affected storage facility/facilities. Therefore, NG NTS submitted a revised NEC Safety Case to the HSE. This included a new type of emergency (a Gas Safety (Management) Regulations (GS(M)R) Monitor Breach Emergency) during Stage 1 of which the NEC can instruct shippers and storage operators to amend storage flows. The revised NEC Safety Case was accepted by the HSE in March 2005. It is important to note that there was no consultation with interested parties, such as shippers, suppliers and customers in relation to these changes to the NEC Safety Case[6].

[6] Requirements relating to the revision of Safety Cases are provided in Regulation 4 of the GS(M)R (see http://www.opsi.gov.uk/si/si1996/Uksi_19960551_en_2.htm#mdiv4). There is no specific requirement for consultation in relation to Safety Case revisions. In addition, there is a Memorandum of Understanding (see http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/3173_hse_mou.pdf) between the Authority and the HSE which outlines working arrangements between the two parties which involve co-operation and effective consultation.

As part of its May 2005 Preliminary WOR[7], NG NTS published its indicative Safety Monitor levels under two scenarios. In the light of feedback on the consultation document and its view of the impact of the supply shocks caused by a potential increase in demand for Liquified Natural Gas (LNG) in the United States on account of Hurricanes Katrina and Rita, NG NTS revised its Safety Monitors as outlined in the Final WOR[8]. The Safety Monitor levels referred to in these documents are contained in the table below.

	Preliminary WOR		**Final WOR**
Storage type	**Scenario 1**	**Scenario 2**	**Base case**
Long duration storage (Rough)	6.2%	17.2%	22.9%
Medium duration storage (MRS)	5.0%	12.1%	12.7%
Short duration storage (LNG)	18.2%	54.4%	26.4%

NG NTS also committed to keeping the Safety Monitor levels under review throughout the winter period.

The Modification Proposal

NG NTS submitted modification proposal 035 "Revisions to Section Q to Facilitate the Revised NEC Safety Case" on 13 July 2005.

This proposal seeks to align the UNC with the revised NEC Safety Case in two ways:

1) by introducing the ability for the NEC to direct users and storage operators, via the relevant transporter(s), to turn down or curtail their deliveries of gas to the system in the event of a potential or actual GS(M)R Safety Monitor Breach under Stage 1 of a NGSE. The modification proposes that:

   - a potential and/or actual GS(M)R Safety Monitor Breach be separately defined as a type of Network Gas Supply Emergency (NGSE); and
   - the relevant transporter(s), on instruction from the NEC, be allowed to direct the relevant storage operators to reduce or cease flowing gas in the event of a potential or actual GS(M)R Supply Monitor Breach.

2) by clarifying the revised roles and obligations post Network Sales. The modification proposes that:

[7] 'A Consultation on Winter 2005/06', NG, May 2005 available at: http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/11584_14405b.pdf?wtfrom=/ofgem/whats-new/archive.jsp

[8] 'Winter Outlook Report 2005/06', NG, October 2005 available at: http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12493_214_05.pdf?wtfrom=/ofgem/whats-new/archive.jsp

- with the declaration of a NGSE, NG NTS will identify demand side steps including demand reduction at Distribution Network (DN) offtakes, at which point it will then become the responsibility of the Distribution Network Operator (DNO) to identify consequential demand side steps within the DN; and
- with the declaration of Stage 4 whereby gas is allocated, NG NTS will allocate gas by LDZ, at which point it will then become the responsibility of the relevant DNO to allocate gas within the LDZ.

The modification proposal suggests several further amendments to provide clarity including:

- that the NEC may declare NGSE stages (1-5) to prevent a supply emergency occurring either sequentially or by declaring a number of stages together; and
- that trades completed on the On-the-day Commodity Market (OCM) before the OCM market has been suspended will be included within the relevant shipper's imbalance calculation.

Respondents' views

This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received.[9]

Nineteen responses were received in relation to modification proposal 035. Of these responses, sixteen respondents were against implementation of the modification proposal, two respondents were in support of the proposal and one respondent offered comments.

Respondents supporting the modification proposal

The proposer was of the view that the primary aim of the modification proposal was to ensure that the UNC was aligned with the NEC Safety Case and duties under the GS(M)R in relation to a potential or actual Safety Monitor Breach. Additionally, the proposer was of the view that the proposal would establish a clear communication path between the NEC and various industry parties without materially altering the commercial position of any industry participant in the event of a potential or actual Safety Monitor Breach.

In terms of the effect of the proposal on storage usage, the proposer did not consider that the proposal would encourage users to withdraw their gas prematurely but would clarify the need for shippers to retain the ability to call on stored gas as part of a portfolio of supply options. Furthermore, while noting that the potential for exposure to high gas prices may increase for some users, the proposer considered that this should be balanced against the benefit to industry of ensuring that sufficient storage stocks are maintained. The proposer was also of the view that storage investment decisions are based primarily on the likely normal operation of a storage facility. Given that Network Gas Supply Emergencies are rare events, the proposer considered that the proposal would not have a material impact on the economics of investment.

[9] Respondents views can be found on the Gas Transporters information service (formally known as Nemisys)) https://gtis.gasgovernance.com

The one respondent other than the proposer who offered support for the proposal considered that the modification consultation process should not be used as the vehicle to discuss the issues surrounding a Shipper's commercial decision to acquire and use peak gas, or the pros and cons of the NEC's right to curtail its use. The respondent supported the view of the proposer that the Proposal was solely about adding clarity to the UNC by aligning the relevant documents.

Another respondent who offered comments stated that they were unable to either support or oppose the proposal because they did not think that due process had been followed. This respondent noted that they were interested to find out how NG NTS could consider entering into contracts for turndown to protect the Safety Monitors and avoid the system entering into an emergency.

Respondents against the modification proposal

Process: NEC Safety Case Change

The majority of respondents who were against the modification proposal expressed concern over the process that was followed with respect to the modification proposal. These respondents were of the view that consulting the wider industry on the proposed Safety Case changes would have ensured that the HSE had a broader understanding of the impact of the changes on the system and the implications of the changes on the behaviours of market participants.

A number of respondents noted that the changes to the NEC Safety Case would have significant commercial impacts on industry. One respondent considered that any such changes should be considered in parallel with changes to the UNC. In line with this view another respondent considered that changes to the Safety Case should be developed with industry prior to modification proposals being raised.

A further respondent noted that while it understood that rejection of the proposal would not affect the physical response provided in an emergency, the implementation of the modification proposal would give undue legitimacy to the Safety Case changes when it was not clear that the proposal would better facilitate the relevant objectives. This view was shared by another respondent who noted that retrospective legitimacy should not be given to Safety Case changes via modifications to the UNC.

Two respondents against the modification proposal noted that they did not object to the post Network Sales changes outlined in the proposal, but stated that they did disagree with the changes proposed to reflect the change in the Safety Case.

Command and Control versus Markets

Several respondents against the modification proposal considered that the modification proposal was inconsistent with NG NTS's residual balancing role. One respondent commented that the proposal provided NG NTS with an additional active role outside the OCM which was not in line with modification proposal 013a.

One respondent was of the view that the use of command and control procedures along side market mechanisms would create the potential for unintended consequences and perverse incentives that

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may prove destabilising to effective market operations. On a related point, another respondent considered that NG NTS's interference in the market in Stage 1 of an emergency would impinge on Users' ability to respond to market signals to avert an emergency. A further respondent considered that the use of command and control along side the OCM would fundamentally undermine the commercial contracts struck between shippers and storage operators. One respondent noted that when the market is not functioning, an actual Stage 2 emergency should be called as this would be in line with modification proposal 635[10].

A further respondent against the modification proposal considered that if market prices were insufficient to avert a potential or actual emergency, it would not be appropriate to expropriate the rights of a single user. In line with this view another respondent considered that the NEC's actions to constrain storage withdrawals would constitute direct interference with the operation of the market which would lead to user discrimination. This respondent was of the view that if the market was not suspended, users' cooperation with the NEC's instructions may be unduly influenced.

Incentives to withdraw gas prematurely

Twelve of the sixteen respondents who opposed implementation of the modification proposal expressed concern that the modification proposal would increase incentives on users to deplete gas in store at a faster rate then they otherwise may have done.

One respondent considered that the incentive to withdraw gas prematurely would increase the balancing cost exposure of storage users and increase the likelihood of command and control actions being taken prematurely. In line with this view another respondent noted that as storage stocks approached the monitor levels the incentive would be to withdraw gas to cover balancing costs. This respondent went on to note that this would not be in the interests of consumers. A further respondent noted that premature withdrawal of gas to fund balancing costs would be a particular problem for storage types with third party access where no single user can prevent a Monitor Breach being caused by other large users.

One respondent considered that if it became apparent that a potential breach of a Safety Monitor was imminent, the market may 'over react' and prices may become artificially inflated, adding further incentive for users to withdraw more gas from storage. This respondent was of the view that the proposal could potentially be counterproductive to security of supply as storage facilities are exhausted on relatively low demand days. One respondent noted that an adverse market reaction is neither economic nor efficient and would only quicken or prolong an emergency.

A further respondent considered that as storage levels reduce, users may be reluctant to nominate storage withdrawals at times of relative system stress for fear of breaching a Safety Monitor and therefore if implemented the proposal would lead to distortions in market behaviour.

[10] Modification proposal 635: "Changes in Gas Supply Emergency Arrangements".

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Discrimination

A significant number of respondents who did not support the implementation of the modification proposal expressed concern that the modification proposal was discriminatory toward users using different tools to balance their portfolios.

One respondent considered the proposal created differences between storage and beach supplies which would alter the value of different assets and impact on long term development. This view was shared by another respondent who considered that the proposal appeared to increase the commercial disparity between gas in storage and other forms of gas entering the system. This respondent considered that the Proposal may be perceived to undermine the value of storage as an appropriate balancing tool at times of system peak, and thus adversely affect investment in storage.

Another respondent noted that given that storage is only one form of flexibility the proposal is highly discriminatory against this class of user. A further respondent considered that the modification proposal risked putting additional costs on to users of certain classes of storage rather than sharing the costs of securing the system.

One respondent expressed concern that NG NTS's ownership of the UK's LNG storage facilities would influence the determination of the Safety Monitor levels and their allocation to different storage types which would cause undue discrimination against other storage types. This respondent noted that the Proposal may raise concerns with respect to Chapter 2 of the Competition Act 1998.

Investment in Storage

A number of respondents considered that the modification proposal, if implemented, would adversely affect the value of storage and thereby reduce the incentive to develop new and existing storage assets.

One respondent stated that investment in new storage would change as shippers looked to sign more flexible gas supply contracts in an attempt to mitigate the increased balancing risk. This respondent noted that as market risks and commercial incentives changed there was a possibility that new storage assets currently being built would not be completed. This view was shared by another respondent who noted that storage operators would have to reconsider their commercial terms to take account of circumstances over which they would have no control, and this could affect the viability of existing and new facilities.

One respondent considered that any proposal which supersedes existing contractual arrangements to prevent users withdrawing gas when it is of most value to them is fundamentally flawed and would reduce the incentive to develop storage assets, threatening long term security of supply. Another respondent noted that increased investment risk in storage facilities will ultimately lead to increased gas supply costs to end users.

One respondent was of the view that further to creating a disincentive to build new or enhance storage facilities, the modification proposal would make users reluctant to purchase storage capacity if there was a possibility it will be constrained.

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Interruption

Several respondents who did not support the modification proposal were concerned that the likelihood of customers being interrupted would increase if the proposal were to be implemented. One respondent noted that interruption was one tool available for use after a storage monitor was breached and given that prices would likely be high at this time, users would interrupt as many customers as they could.

A number of respondents considered the probability of transporter interruption during Stage 1 of an emergency would increase if the modification proposal were implemented. One respondent expressed concern that a misdirected proposal would in effect lead to consumers balancing the system. This respondent was also of the view that it was not reasonable to expect transporters, users and customers to enter into new interruptible contracts when the expectation was that the contractual environment would be changing over the next two years.

Cash-out Exposure

A number of respondents were of the view that the modification proposal would penalise users by exposing them to high imbalance prices. These respondents were of the view that the days when storage was constrained would likely be high prices days and users who were less likely to remedy a short position would be hit by a penal marginal emergency cash-out price. One respondent considered that users out of balance through no fault of their own would likely be penalised through these high prices as a distressed buyer in the market. A further respondent noted that exposure to high cash-out price could act as a disincentive for Users to put gas in storage, or could incentivise Users to withdraw gas early.

Compensation Arrangements

Several respondents were of the view that Users should be compensated for the gas that is effectively locked in store as would be the case if the modification proposal were implemented. One respondent noted that shippers should be entitled to receive a payment from NG NTS to cover any resulting imbalance position which may arise from gas being effectively locked in store. Another respondent commented that gas locked in store was one of a number of tools for managing system security including offshore reserve and interruption, and like other products should come at a price. This respondent was surprised that NG NTS had not suggested compensation for users for the gas it would in effect take title to at a time when the market was still operating.

One respondent was of the view that without a compensation scheme the modification proposal created discrimination between different users. The respondent noted that Shippers bringing gas from offshore would have the fall back of being compensated for any losses from having to curtail or flow extra gas onto the system through the claims process.

Storage Monitor Levels

A number of respondents expressed concern related to the storage monitor levels. One respondent considered that the proposed monitor levels would likely be set at a very high level and they could therefore potentially be breached on a normal demand day. This respondent was of the view that in

a price sensitive market, this could lead to high prices and users choosing to take their gas out of store in anticipation of emergency curtailment.

One respondent considered that NG NTS hadn't sufficiently explored the possibility of providing additional clarity and timely information regarding Storage Monitor levels such that the market could take corrective action prior to the potential/actual GS(M)R Monitor emergency being called.

Another respondent considered that the Storage Monitor approach to declaring an emergency was too simplistic as the Monitors were based on gas in store which overlooked the critical contribution of injectability and deliverability on security of supply.

One respondent was of the view that the lack of transparency in setting storage monitor levels created uncertainty for market participants in relation to the ability to realise the full market value of storage.

Demand Side

A number of respondents opposed to the modification proposal were of the view that NG NTS had not sufficiently explored options for encouraging demand side response prior to raising the modification proposal. One respondent noted it was likely that peak day supplies would be limited if the proposal were implemented increasing the need for demand side management. This respondent commented that in NG NTS's licence, NG NTS had the ability to use a number of tools to manage the network including options for entering into commercial contracts with users. This respondent stated it was their view that NG NTS should look to engage in such contracts rather than compromise the commercial position of a few users. This view was shared by a number of respondents, one who noted they believed that by facilitating these types of contracts NG NTS would be further developing the relevant objectives of their licence by maintaining a safe economic and efficient pipeline system.

One respondent who offered comments noted they were interested to find out how NG NTS could consider entering into contracts for turndown to protect Safety Monitors as this would be a residual balancing role that would protect the gas system from entering into an emergency.

Top Up

Several respondents made reference to the modification proposal 710, "the removal of Top up". One respondent noted it was their understanding that the reason for the removal of top up arrangements and subsequent introduction of Safety Monitors was to allow the market to respond to supply and demand fundamentals without the need for intervention by NG NTS, which appeared at odds with this proposal.

One respondent noted that the changes NG NTS made to the Safety Case undermined the basis for consideration and acceptance of 710 and the Safety Case change and proposed modification would now result in the associated top up cost risks being placed on storage users.

Other Issues

Respondents against the implementation of the modification proposal raised several other concerns relating to the modification proposal.

A number of respondents requested clarification of certain areas of the legal text including defining "imminent" and making a distinction between "potential" and "imminent". Respondents were of the view that clearer definitions would aid the market in its understanding of an imminent breach.

Panel recommendation

At the Modification Panel meeting held on 20 October 2005, of the 9 Voting Members present, capable of casting 10 votes, 4 votes were cast in favour of implementing modification proposal 035 "Revisions to Section Q to Facilitate the Revised NEC Safety Case". Therefore, the Panel did not recommend implementation of this modification proposal[11].

Ofgem's view

Ofgem has carefully considered the views of respondents and the Panel in relation to modification proposal 035. Having regard first to its principal objectives and secondly its wider statutory duties Ofgem has decided that on balance it has not been demonstrated that modification proposal 035 would better facilitate achievement of the relevant code objectives compared to the existing UNC. In rejecting this proposal, Ofgem understands that the arrangements will continue to be in place under the NEC Safety Case. Ofgem considers that the Safety Monitor arrangements should be urgently reviewed and that revisions to these arrangements, which are capable of implementation for this winter, should to be developed in a transparent manner.

Ofgem fully accepts the need for the NEC to have access to a volume of gas to ensure that those customers that can not be protected by isolation are guaranteed safety in the event of a gas emergency. However, Ofgem considers that the current arrangements for Safety Monitors might impose perverse commercial incentives on both market participants and on NG NTS. Below, Ofgem briefly:

- sets out why it considers that the current Safety Monitor arrangements have shortcomings; and
- provides its views on the proposed modification.

Shortcomings of the existing Safety Monitor regime

The Safety Monitors are designed to ensure that sufficient gas remains in storage to guarantee the safety of those customers that are unable to be protected by isolation and thereby protect public safety. To the extent that the volume of gas identified by the Safety Monitors is required for this purpose, Ofgem considers that appropriate arrangements should be in place to ensure that this

[11] A Panel recommendation requires a majority vote from voting members at a quorate meeting of the Modification Panel.

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volume of gas is made available to NG NTS in the run up to and in the event of an emergency. However, it is Ofgem's view that the current arrangements for Safety Monitors potentially place perverse commercial incentives on market participants and, because of this, may not operate as intended. Furthermore, it is Ofgem's view that the current arrangements may not facilitate the economic and efficient operation of the system by NG NTS. Ofgem believes this to be the case for the following reasons:

- **NG NTS has no commercial incentives to manage costs.** Under the existing Safety Monitor arrangements, NG NTS does not incur any costs (or face any incentives to manage them efficiently) in relation to requiring a volume of gas to be held in storage or by curtailing market participant's planned flows out of storage. Clearly, however, these actions are likely to impose significant costs on market participants. Ofgem considers that, by not being exposed to the costs of its actions in this respect, NG NTS may not have appropriate incentives to operate the system in an economic and efficient manner. This may lead, for example, to NG NTS being too pessimistic in forecasting the likely supply/demand balance and over-estimating the monitor requirement. This set of arrangements contrasts to those in the electricity sector in which NG Electricity Transmission (NGET) has incentives to manage the cost of the services it requires to ensure it can undertake its role as System Operator (SO) and these appear to be working effectively;

- **Perverse incentives on users.** Users are not compensated for the actions taken by NG NTS in relation to its Safety Monitor obligations but may incur costs because of NG NTS's actions. They are likely, as a result, to take action to avoid having these costs imposed upon them. One action by market participants might be to withdraw their gas from storage earlier than might have otherwise been the case to mitigate the risk of being subject to the monitor restrictions imposed by NG NTS. This might result in faster depletion of gas from storage sites than would have otherwise occurred, thereby encouraging inefficient use of storage. *In extremis*, the faster drawdown of gas from storage that the arrangements are likely to encourage may increase the risk of an emergency situation developing. Again this set of arrangements contrasts to those in the electricity market in which participants receive payment for the provision of the balancing services (such as reserve) required by the system operator and therefore are incentivised to offer such services to the SO;

- **Lack of transparency.** To date there has been insufficient transparency concerning the methodology employed by NG NTS when setting and revising the Safety Monitor levels. There was, for example, a significant and unexpected change in the Safety Monitor levels made by NG NTS shortly before the winter. This has the effect of creating further uncertainty amongst market participants as to the level of gas needed to meet the Safety Monitor requirement. Ofgem also shares the majority of respondents' concerns that the process that NG NTS adopted through revising the NEC Safety Case lacked transparency particularly as these issues have a commercial impact on shippers; and

- **Discrimination.** By explicitly targeting gas in store, the Safety Monitor arrangements could discriminate between competing sources of gas, potentially distorting competition between them. The current arrangements oblige NG NTS to take actions to ensure that the system remains secure. However, it is Ofgem's view that the option of maintaining a certain volume of gas in storage is only one of a number of options available to NG NTS in

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meeting its safety requirements. Ofgem considers that, to the extent that NG NTS requires a volume of gas to ensure the safe run down of the system, NG NTS should seek to procure it from the most efficient and economic source, rather than focusing on solely gas in store. Ofgem notes market based procurement is used by NGET when it procures reserve contracts from market participants to cover eventualities such as plant breakdown and demand forecasting errors.

It is clear that the current arrangements need to change to address these issues. But these changes will require discussion with shippers and customers and may require further modifications both to the UNC and NG NTS's licence. It will not, therefore, be possible to seek to address all of these issues for this winter and, given the timetable against which NG NTS has raised these issues, it is necessary to consider whether this proposal better facilitates the relevant objectives knowing that deficiencies exist with the current Safety Monitor arrangements.

We now turn to the details of UNC modification proposal 035. Ofgem considers that it is appropriate to consider this proposal primarily against relevant objectives (a) and (d). Ofgem notes that several respondents and Panel members considered the modification proposal against relevant objective (c). However, Ofgem does not consider that this is relevant as the GT licence does not specifically have any obligations in relation to Safety Cases or their alignment with the UNC. In this case, Ofgem considers that obligations in the GT licence in relation to efficient and economic operation of the system can be assessed through consideration of relevant objective (a).

Standard Special Condition A 11 (a) – the efficient and economic operation of the pipe-line system to which this licence relates

Perverse incentives to withdraw gas from store

Ofgem recognises that the intended effect of modification proposal 035 is to introduce into the commercial framework of the UNC the concept of a GS(M)R Monitor Breach Emergency and to enable the NEC to maximise or curtail storage flows during Stage 1 of a Monitor Breach emergency. Of critical importance is the fact in seeking to do this, modification proposal 035 does not propose any compensation arrangements associated with the ability for the NEC to amend storage flows.

In this respect, Ofgem agrees with the majority of the respondents that enabling the NEC to maximise or curtail storage in Stage 1 of a GS(M)R Monitor Breach Emergency without any form of compensation creates perverse incentives for storage users to withdraw gas in advance of a GS(M)R Monitor Breach Emergency. Ofgem considers that this would not operate to achieve the efficient and economic operation of the system, as these perverse incentives increase the risk that the system will go into an emergency faster than would otherwise have been the case or in circumstances where an emergency would otherwise have been avoided. Ofgem, therefore, considers that, in this respect, modification proposal 035 does not better facilitate the achievement of relevant objective (a).

Emergency interruption in Stage 1

Ofgem also notes that modification proposal 035 attempts to introduce into the commercial arrangements the ability for the NEC to undertake emergency interruption in Stage 1 of a GS(M)R

Monitor Breach Emergency. Ofgem recognises that during Stage 1 of a Gas Deficit Emergency (GDE) when there is a supply shortfall, emergency interruption may be required. However, Ofgem is concerned that in the context of a GS(M)R Monitor Breach Emergency it may not be appropriate for the NEC to have the ability to conduct emergency interruption of end-users because a Safety Monitor Breach could occur in the absence of a supply shortfall. In any event, Ofgem considers that it is preferable for the market to provide demand side response, ahead of utilising NEC initiated emergency interruption. On this basis, Ofgem considers that it is important for the arrangements to allow the market to deliver demand side response before taking steps to initiate emergency interruption.

Furthermore, as a Safety Monitor Breach is not an imminent supply and demand emergency, Ofgem considers that clearer differentiation is required between the two situations and the tools that the NEC can utilise in each. Ofgem also considers that in the event of a Monitor Breach, it should be made clear that this is distinct from a GDE and is not a system wide supply and demand emergency. Therefore, given these concerns about the appropriateness of emergency interruption in a GS(M)R Monitor Breach, Ofgem considers that this aspect of modification proposal 035 may not better facilitate the achievement of relevant objective (a).

Impact on storage

Ofgem also considers that the introduction into the commercial arrangements of storage curtailment as outlined in modification proposal 035 could interfere with the operation of privately owned natural gas storage facilities. Ofgem agrees with respondents who considered that the ability of the NEC to curtail storage flows creates uncertainty as to the ability for shippers to access their gas in store. Given that curtailment can occur in Stage 1 of an emergency, when other aspects of the gas market may be operating normally, and that shippers do not receive any compensation for this, the value of storage products to shippers may be eroded by modification proposal 035. This may lead shippers to hold less storage than would otherwise be the case. In this case, storage stock levels would be closer to the Safety Monitor levels with the implication that a GS(M)R Monitor Breach Emergency may be more likely. Ofgem, therefore, considers that, in this respect, modification proposal 035 does not better facilitate the achievement of relevant objective (a).

A further potential implication on storage which falls out of the uncertainty highlighted above relates to the effects of this modification proposal on investment in storage facilities in the longer term. Ofgem agrees with respondents that there is the potential for modification proposal 035 to have a detrimental impact on the economics of investment in storage facilities. If this occurs, reduced investment in storage facilities would be likely to have a negative impact on the efficient and economic operation of the pipeline system.

Therefore, as a result of both of these potential impacts in storage, Ofgem considers that modification proposal 035 does not better facilitate the achievement of relevant objective (a).

Consistency between Safety Case and UNC

Ofgem acknowledges that in raising modification proposal 035, NG NTS was seeking to align the UNC with the Safety Case. Ofgem considers that, where appropriate, it is important for there to be consistency between the UNC and the Safety Case in order to provide clarity as to the

arrangements, which should enhance the efficient and economic operation of the system. However, in this case, Ofgem shares the concerns raised by respondents in relation to the non-transparent manner in which the NEC Safety Case changes were progressed. Given the commercial implications for storage users in particular, Ofgem agrees that NG NTS should have ensured that market participants were consulted in relation to the NEC Safety Case changes. In the absence of any consultation exercise which could have enabled consideration of the commercial implications of the NEC Safety Case change, Ofgem considers that the Safety Monitor arrangements which are now in place may give rise to perverse incentives on market participants and NG NTS. Given NG NTS's obligations in respect of the UNC, its licence and the GS(M)R, Ofgem would expect NG NTS to ensure that transparent processes are followed in the future when issues which affect the both UNC and Safety Cases are considered.

Furthermore, in this case, Ofgem does not consider that this modification better facilitates the economic and efficient operation of the pipe-line system and, as such, does not consider that achieving consistency between the UNC and the Safety Case is appropriate in this instance. This applies to modification proposal 035 in its entirety and so applies to both elements of the proposal (i.e. the proposed changes in relation to the arrangements post-Network Sales as well as those in relation to the Safety Monitor arrangements). Ofgem considers that, going forward, there may be merit in seeking to progress the DN sales related element of this modification proposal separately from the Safety Monitor element.

Ofgem's view against relevant objective (a)

In conclusion, Ofgem considers that modification proposal 035 would not better facilitate the achievement of relevant objective (a).

Standard Special Condition A 11 (d) – securing of effective competition between the relevant shippers and suppliers

Discrimination linked to curtailment of storage in Stage 1

Ofgem considers that modification proposal 035 would if implemented introduce into the commercial arrangements discrimination between competing sources of gas. This modification proposal could discriminate against shippers who have booked storage space to cover their own commercial positions over those shippers who have contracted for other sources of gas, placing the shippers with gas in store are at a disadvantage when compared with shippers who do not use storage. Currently, beach gas is subject to command and control in Stage 2 of an emergency, whereas storage is curtailed/maximised in Stage 1. Ofgem considers that the differences in operations could potentially discriminate between two competing sources of gas. Therefore, Ofgem considers that this modification proposal, if accepted, would not promote effective competition between the relevant shippers and suppliers.

As mentioned above, Ofgem shares the concerns raised by respondents in relation to the absence of appropriate compensation for storage users who have had their flows from storage curtailed. Ofgem agrees that this could unfairly discriminate against storage users who, having contracted for gas in store to cover their commercial positions, could lose their ability to access their gas in store without receiving any compensation. The affected shippers would then be in a position of having to

procure gas from a different supply source at prompt prices or face exposure to the System Marginal Buy Price (SMP Buy) for any imbalance that results from the storage curtailment. Therefore, Ofgem considers that this arrangement could unfairly discriminate against storage users and as such is of the opinion that it would not better facilitate the achievement of relevant objective (d). Ofgem is of the view that if this element of the Safety Monitor arrangements is to be incorporated into the commercial framework of the UNC, it is essential for there to be appropriate compensation for affected storage users (as discussed further below).

Discrimination linked to emergency interruption in Stage 1

As discussed above, modification proposal 035 attempts to introduce the ability for the NEC to undertake emergency interruption in Stage 1 of a GS(M)R Monitor Breach Emergency. In addition to the points already raised in relation to this aspect of the modification proposal, Ofgem considers that emergency interruption in Stage 1 may unfairly discriminate against end-users who are on interruptible contracts because NG NTS has discretion as to when and if the interruptible end-users come off of the system. Therefore, Ofgem considers that this aspect of modification proposal 035 may not better facilitate the achievement of relevant objective (d). Since the acceptance of UNC modification proposal 013a, interruptible contracts are only intended to give NG NTS interruption rights for transportation constraint resolution purposes. Therefore, Ofgem considers that there may be merit in considering the interruptible arrangements as a whole during an emergency.

Ofgem's view against relevant objective (d)

In conclusion, Ofgem considers that modification proposal 035 would not better facilitate the achievement of relevant objective (d).

Summary

Overall, for the reasons outlined above, Ofgem considers that it has not been demonstrated that modification proposal 035 would better facilitate the achievement of the relevant objectives. The following section outlines ways in which the issues that Ofgem has identified with modification proposal 035 may be overcome.

Wider issues

As highlighted previously, Ofgem considers that there are several shortcomings in relation to the Safety Monitors arrangements. To overcome these issues, Ofgem considers that the arrangements would benefit from further consideration by interested parties. In Ofgem's view, there are some measures that could be introduced in the near term, and those that may need to be considered ahead of next winter.

In the short term, it is Ofgem's view that the Safety Monitor arrangements would benefit from consideration in the following areas:

- **Emergency interruption.** Ofgem considers that the ability for the NEC to undertake emergency interruption in Stage 1 of a GS(M)R Monitor Breach Emergency could potentially be distorting the incentives for the market to provide demand side response.

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Additionally, Ofgem expects that the market would be able to provide response more efficiently than NEC initiated emergency interruption. Allowing the market to operate in Stage 1 would reduce the likelihood of an emergency and deliver a more efficient solution than command and control based emergency interruption. It is important to clearly delineate between a GDE and a GS(M)R Monitor Breach and the options available to the NEC under each of them. Therefore, given that a GS(M)R Monitor Breach is not necessarily linked to a supply/demand mismatch, Ofgem considers that the NEC should not have the ability to conduct emergency interruption in Stage 1 of a GS(M)R Monitor Breach Emergency.

- **Information release.** In the event of a potential or actual breach, it is important for the information issued to be clear that a GS(M)R Monitor Breach is different from a GDE. In this respect, the key is that a Monitor Breach is not necessarily indicative of system-wide supply and demand problems. Therefore, Ofgem considers that any revisions to the arrangements should carefully consider the information release associated with a Monitor Breach.

- **Compensation for shippers.** As noted above, by not providing shippers with compensation for restriction of their acquired rights to use storage, there is a risk that any individual shipper will distort its usage of storage so as to drawdown on it more quickly than they might otherwise do. In turn, this risks reducing, in aggregate, the volume of gas held in storage, to the overall detriment of the system. It is Ofgem's view that there are two potential approaches to compensating shippers that might merit further consideration. They are:

    - *compensation to all shippers for loss of optionality*. The Safety Monitors can clearly restrict storage users' access to and use of their storage rights. This reduces the value of storage to users. The risk of restriction (and the reduction in value) increases as the level of the Monitor increases. It may be appropriate to compensate all shippers that hold storage for the risk that their use of storage is restricted. Compensation could be based on an estimate of the value lost because of the Monitor restrictions. This could mitigate the long term detrimental effects of the Safety Monitors on storage sites as the value to shippers. It may, however, not mitigate the perverse incentive on shippers to use their storage more quickly than they might have otherwise done; or

    - *compensation for affected shippers only*. An alternative approach might be to only compensate shippers that are actually affected in the event that the Safety Monitor levels are breached. Given that the shippers continue to own the gas that is in store, compensation could be based on the difference between the value of the gas held in store on the day or days that the restriction applies relative to the value of gas when the restrictions are lifted. Under this approach therefore shippers might, for example, receive System Average Price (SAP) on the day of the storage restrictions *minus* a proxy for the price of the gas at another point in the future such as the average of SAP over the remaining days of the winter following the lifting of the restrictions. The volume of gas that the shipper might receive compensation for might be equivalent to the shipper's nominated withdrawals (taking into account the

allocation process) from that storage facility. This approach could have the benefit of mitigating the tendency for shippers to drawdown their storage to avoid the restrictions. However, a potential downside of this type of approach is that it might reduce the incentives on affected shippers to balance their inputs and offtake on the day that the limitations to storage apply and therefore creating an enhanced role for NG NTS as the residual balancer.

- **Improved transparency.** Ofgem agrees with respondents that NG NTS should provide market participants with more information regarding its methodology for determining the level of the Safety Monitors[12] and any subsequent revisions to the monitor levels.

Ofgem considers that these incremental changes to the current regime as set out above could be considered in the context of the current winter period. However, Ofgem thinks that a more fundamental review should be carried out ahead of next winter. Under a revised set of arrangements, NG NTS should have appropriate commercial incentives to procure any gas required to ensure safe run down of the system to protect customers efficiently. This would encourage NG NTS to consider alternative sources of gas to storage where they are cheaper. Ofgem expects to initiate a review of these arrangements shortly. This review process will call on input from all market participants, including NG NTS. Ofgem will highlight its timetable to market participants in the coming weeks.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to accept modification proposal 035.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Simon Bradbury on 020 7901 7249 or Fiona Lewis on 020 7901 7436.

Yours sincerely

Steve Smith
Managing Director, Markets

[12] Ofgem acknowledges that NG NTS has published a revised version of its Safety and Firm Gas Monitor Methodology ('Safety & Firm Gas Monitor Methodology', NG NTS, November 2005).

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