Modification Report
Revision of the Emergency Cash-out Price
Modification Reference Number 0042

Version 2.0

This Modification Report is made pursuant to Rule 10 of the Modification Rules and follows the format required under Rule 9.6.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 10.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because it considered that if this 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 likely impact of the modification and react accordingly, prior to this coming winter."

Ofgem also considered that if this Modification Proposal were "not treated as urgent, this could have an impact on security of supply for the winter ahead."

Procedures Followed:

The procedures agreed with Ofgem for this Proposal are:

Sent to Ofgem requesting Urgency	09/08/2005
Ofgem grant Urgent status	09/08/2005
Urgent Modification Proposal issued for consultation	09/08/2005
Closeout for representations (9 business day consultation)	22/08/2005
FMR issued by Joint Office (+4 business days)	26/08/2005
Panel approve that response reflected appropriately	31/08/2005
Modification Panel Recommendation	02/09/2005
Ofgem decision expected	07/09/2005

1. The Modification Proposal

The Proposal was as follows:

"This proposal seeks to amend the current Emergency Cash-out price from the prevailing single price of the 30 day average SAP to a single price of the prevailing SAP.

We have raised this Proposal to address the perceived issue that the current Emergency Cash-out price does not provide the most appropriate incentives on Users to make suitable provision to avoid entering into Gas Deficit Emergency (GDE). This Proposal seeks to provide the appropriate incentives on Users to address this concern.

In response to industry concerns raised in representations to modification 021, we consider that this proposal strikes the appropriate balance between the proposed emergency cash-out prices in modification 021 and the current single cash-out emergency price of 30 day average SAP.

In Ofgem's decision letter to modification proposal 021, two key areas were identified:

- **The need to ensure that there are appropriate incentives to encourage Users to take appropriate actions, through which as GDE might be avoided, or its duration or extent reduced.** Setting the emergency cash-out price at the SAP on the day provides the appropriate incentives for shippers to balance their inputs and offtakes, leading up to an emergency.

When considering different emergency cash-out prices, such as the current 30 day average SAP and the dual price, suggested in modification proposal 021, the SAP on the day emerges as the most pragmatic option for setting the emergency cash-out price. GDEs may be rapid or progressive, and where rapid, setting the emergency cash-out price at SMP Buy could penalise Users, where the shipper may not have time to react to improve its imbalance position and thus avoid an emergency, the imbalance price paid would, therefore, be disproportionate. This proposal ensures that Users are not exposed to extremes but at the same time are suitably incentivised to take action to prevent a GDE from occurring.

The SAP reflects a fair market value of the gas and will reflect the tightness of the market but, where a sudden price spike occurs, such as following a major failure of a terminal, those Users, who are short, would be unduly discriminated against through a penal cash-out price if the buy price was set at SMP Buy. Only a small volume of energy could lead to setting the SMP Buy, which could potentially lead to shipper failure.

The SAP is transparent and brings a fair reward for Users which are long and provides an appropriate incentive to those Users, which are short.

This proposal has further advantages of reducing the number of claims where a User believes that it will suffer a financial loss by reason of being paid only the relevant price. This financial loss should be minimised through a more market reflective emergency cash-out price, rather than the 30 day average SAP.

- Whether the 30 day average SAP was high enough to incentives price sensitive gas to flow to the UK when a GDE has been declared. We do not consider that any proposal, which seeks to incentivise price sensitive gas to flow to the UK when a GDE has been declared, through altering the emergency cash-out price, can have any significant affect with regards to price sensitive flows, such as the interconnector. Experience of late February and March of this year suggests that where the price of gas in the UK was such that short term financial gains could be realised, the interconnector remained exporting to the continent. We believe that this is owing to the long-term value on the continent associated with commitment to customers in ensuring their supplies are maintained. We have not therefore, sought to address this concern, through this modification proposal.

  Furthermore, the NEC can request, via Transco NTS, the cooperation of interconnectors to prevent a potential or actual supply emergency occurring. We would argue that this provides sufficient provisions to ensure that the interconnector does not unduly export gas from the UK to the continent in the run up to an emergency."

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

The Proposer stated that its Proposal:

"addresses the perceived issue that the current emergency cash-out price does not provide the most appropriate incentives on Users to make suitable provision to avoid entering into a Gas Deficit Emergency (GDE) and therefore better facilitates the following relevant objectives:

"1. (e) the provision 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 consumers, through ensuring the appropriate arrangements are in place to incentive shippers / suppliers, where they have the time and information to react to market signals, to avoid entering into a Gas Deficit Emergency (GDE) and thus minimising the probability of threatening domestic customer supply security.

1. (d) (i) the securing of effective competition between relevant shippers and (ii) suppliers, through targeting cost during an emergency thereby encouraging Users to take appropriate actions to avoid a GDE. Such actions might promote greater and more effective competition between shippers and suppliers."

GDF agreed with the proposer that, if implemented, the Proposal would better facilitate standard Special condition A11.1 (d) and 1(e) of the GT Licence.

SGD believed that this Proposal, "furthers the relevant objectives of the Uniform Network Code by ensuring that effective competition between shippers and relevant suppliers by appropriate and pragmatic approaches are adopted to emergency cash out arrangements."

TNTS noted and "support Ofgems view" that, "through paying shippers that are long the SAP rather than the 30 day average SAP will promote the economic and efficient operation of the system through encouraging price sensitive sources such as the interconnector or LNG storage to flow into the GB market". TNTS stated that, "implementation of Modification Proposal 0042 would better facilitate the Relevant Objectives when compared with the current arrangements." But noted that it deduced, "from Ofgem's decision letter in respect of MP0021 that Ofgem considers there is merit in addressing both "price" and "volume" issues in the context of emergency arrangements." And therefore considered that Modification Proposal 0044, "better facilitates the Relevant Objectives when compared with this Proposal."

SSE was not convinced that, "modifying the existing emergency cashout arrangements would better facilitate any of the relevant objectives."

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

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

"raised this Proposal to address the perceived issue that the current Emergency Cash-out price does not provide the most appropriate incentives on Users to make suitable provision to avoid entering into Gas Deficit Emergency (GDE). This Proposal seeks to provide the appropriate incentives on Users to address this concern."

The Proposer stated that this Proposal, "…suitably incentivises Users to take action to prevent a GDE from occurring."

If implemented, this Proposal may 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.

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

a) implications for operation of the System:

The Proposer has stated that implementation would ensure that "Users are not exposed to extremes but at the same time are suitably incentivised to take action to prevent a GDE from occurring." Should Users take such action, the requirement on the System Operator to take balancing action would be reduced accordingly. This also implies that emergency operation of the System, under the control of the NEC, would be less likely.

b) development and capital cost and operating cost implications:

No such implications have been identified by the Proposer. Major costs have been identified for the relevant Transporter if a GDE were declared and therefore if it is accepted that implementation would make such an emergency less likely there would be a reduction in the risk of incurring the associated operating costs.

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

No suggestions have been made by the Proposer in respect of the recovery of costs. The method of recovery of costs in an emergency is already established and implementation of this Proposal would not affect this method.

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

No such consequences have been identified by the Proposer

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

No such consequence has been identified by the Proposer

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

No such implications have been identified by the Proposer.

TNTS noted in Modification Proposal 0021 (MP0021) that the setting of emergency cash-out prices was a manual task and hence any changes based on a currently defined price calculation should be implementable without any systems changes.

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

Implementation of this Proposal would affect the level of risk under the UNC for Users if a GDE were declared. Users would thus be more incentivised to balance on the day, which the Proposer has argued is a suitable incentive "to prevent a GDE from occurring".

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

It is to be expected that any change in the risk profile of Users would affect both upstream and downstream industry participants.

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

No such consequences have been identified by the Proposer.

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

No specific advantages and disadvantages were identified by the Proposer.

The SME has interpreted the following advantages and disadvantages from views expressed within the Proposal and responses to the Proposal:-

Advantages

The Proposer stated :

- "This proposal strikes the appropriate balance between the proposed emergency cash-out prices in modification 021 and the current single cash-out emergency price of 30 day average SAP."
- "This proposal ensures that Users are not exposed to extremes but at the same time are suitably incentivised to take action to prevent a GDE from occurring."
- "The SAP reflects a fair market value of the gas and will reflect the tightness of the market"
- "The SAP is transparent and brings a fair reward for Users which are long and provides an appropriate incentive to those Users, which are short."

TNTS considered that:- Ofgem has identified that the "collective insurance" provided by the current arrangements has the potential to distort effective competition "as it reduces the incentives for shippers to contract ex ante for additional gas or demand side response, and results in cross subsidy between shippers". This Proposal would be likely to increase the cash-out price under emergency conditions, when compared with the current arrangements, and this would mitigate against these potential distortions.

Disadvantages

No respondent has provided any disadvantages resulting from movement from the prevailing arrangements to the proposed changes, however some respondents identified the following issues:-

- **ENI** considered that this Modification Proposal**,** "fails to address the whole area of "emergency Cash-out" sufficiently."
- **SSE did not** consider that, "to move to a prevailing SAP would incentivise the "right" behaviour as it would not take account of the User's inability to balance once a GDE has been declared."
- **ENI** considered that**,** "a single price of SAP would not sufficiently encourage Shippers to balance and would also increase the risk of significant revenue neutrality action as both long and short Shippers would be cash-out at a common price"

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

Sixteen Representations were received.

Total Gas and Power Ltd	(TGP)	In support
Statoil (UK) Ltd	(STUK)	In support
Shell Gas Direct Ltd	(SGD)	In support
The Association of Electricity Producers	(AEP)	In support
Chemical Industries Association Ltd	(CIA)	In support
Centrica Storage Ltd	(CSL)	Qualified support
E.ON UK	(EON)	In support
Transco NTS	(TNTS)	Qualified support
British Gas Trading	(BGT)	In support
Scottish Power UK Plc	(SP)	In support
Gaz De France	(GDF)	Qualified support
EDF Energy Plc	(EDF)	Qualified support
Scottish and Southern Energy Plc	(SSE)	Not in support
ENI UK Ltd	(ENI)	Not in support
RWE Npower Plc	(RWE)	Not in support

Eight respondents (TGP, STUK, SGD, AEP, CIA, EON, BGT, SP) expressed support for the Proposal.

Four respondents (TNTS, CSL, GDF, EDF) provided qualified support.

Four respondents (SSE, ENI, RWE, 1 confidential representation) did not support the Proposal.

SME comments are made in italics.

General

BGT stated that it had considered whether, "the adoption of the Daily SAP would represent a price closer to the value of the commodity on the day of an emergency that the value of SAP averaged over the previous 30 days." In this respect it expressed support for the implementation of this Modification Proposal. BGT added that, "there remain a number of other issues around the operation of the emergency regime that are in need of further consideration." This view was shared by AEP which, supported the prevailing SAP price being used to set the emergency cashout price, but consider further development and refinement of cashout in an emergency situation should be considered in the future.

CSL was, "mildly supportive of the intent of UNC0042 from the perspective of attracting price sensitive gas to Great Britain was maintaining some of the advantages afforded by single cash out following a failure of the market."

EDF believed that, "this modification has some merits over and above current cashout arrangements in an emergency, and in relation to modification 044 and therefore offer our qualified support." SSE expressed the view that it was not in support of this Modification Proposal, however it would, "reluctantly lend our support to this Modification Proposal in preference to Modification Proposal 0044."

TNTS concluded that, "while both Modification Proposals better meet the Relevant Objectives when compared with the current arrangements, the implementation of Modification Proposal 0044 would be preferable to implementation of this Modification Proposal 0042."

ENI believed that, "the current modification is unacceptable because it does not sufficiently address the issues raised by Ofgem on "Emergency Cash-out Arrangements" and Shippers."

The adoption of the prevailing SAP as the relevant Cash-out price post Market suspension should represent a price closer to the value of the commodity on the day as it is calculated as a weighted average of all trades on the OCM on the day. Whether this betters the relevant objectives or not should be considered against the prevailing UNC arrangements only.

Process

Four respondents (ENI, SGD, SSE and CSL) expressed concerns relating to the limited timescales for development and consultation of this Proposal prior to the coming winter. ENI expressed concerns regarding the timeliness and process of both this Proposal and Modification Proposal 0044. It believed that, "with little time for the thorough consultation and reflection deserving a topic of this importance given potential scenarios this winter." SGD supported this Proposal, "with some, limited reservations." SGD noted a number of concerns, "regarding the processes which have been followed resulting in three urgent proposals being raised on emergency cash-out in the run up to what Ofgem and National Grid have suggested could be a tight winter if very cold." SSE stated that, "Whilst understanding the rationale for following the urgent route, we continue to have concerns that UNC modification proposals addressing serious issues regarding the commercial incentives placed on Users during an emergency are being progressed on an extremely fast-track basis. We believe that this does not afford sufficient time for parties to properly consider all the implications of the changes. A more balanced approach would be to reconvene CORWG which would permit the many issues that have been raised in recent weeks to be properly debated in this forum." CSL expressed concern, "that potential changes of the magnitude proposed in both modifications are being rushed through as urgent modifications." CSL believed, "that the changes are too significant to make without full consideration of the issues – not permitted by the timeframes provided."

CSL believed that, "sufficient disincentive against exacerbating an emergency to seek the protection of neutral cash out rules exist through inter alia shipper licences, GSMR and general competition law and that a rushed assessment of new rules 5 weeks before the start of Autumn is not an efficient or effective process."

RWE believed that the, "short period of time allowed for developing the proposal and responding to it is less than ideal. Whilst we would not dispute the need to ensure this issue is addressed in a timely manner prior to the forthcoming winter in our opinion further time could have been allowed for development and consultation without compromising this."

No procedural breaches have been identified in relation to this Proposal by the SME. While Modification Proposal 0021 was rejected on procedural grounds this was mainly due to the lack of clarity in regard to the use of a UNC defined term and the resulting legal interpretation that a legitimate consultation had not been carried out. No such lack of clarity has been identified within the responses to this Proposal by the SME. It should be noted that there are provisions within the UNC Modification Rules (10.4) that allow for the review of the content of an implemented Urgent Modification Proposal.

Appropriate Incentives and Prices

TNTS noted that the views expressed in Modification Proposal 0044 (MP0044) are relevant to consideration of this Proposal. In that Proposal it stated "Any change to the cash-out price applicable during a GDE should ensure that Users do not have a financial incentive to withhold gas, i.e. the cash-out price for Users with a positive Daily Imbalance should fairly reward those providing gas to assist efficient management of the Gas Deficit Emergency, and ensure that Users have an appropriate financial incentive to offer demand-side response. Transco NTS believes that the cash-out price for Users with a negative Daily Imbalance should reflect the marginal value of demand response. This is important to provide appropriate incentives for Users to cover their short positions. A single cash-out price cannot reflect both these values and hence dual cash-out pricing may be more appropriate."

RWE believed that whilst it has some concern that, "using a marginal price for cashing out negative imbalances may expose shippers to unmanageable risks in the event an emergency develops rapidly", it considered that "on Balance" it was, "preferable to using the current 30 day average SAP or SAP, as it will strengthen the incentive for shippers to balance and offer demand side response." This was a view shared by ENI which, stated that it, "finds modification proposal 0042 unacceptable in its present form because it fails to address the whole area of "emergency Cash-out" sufficiently." ENI considered that, "a single price of SAP would not sufficiently encourage Shippers to balance and would also increase the risk of significant revenue neutrality action as both long and short Shippers would be cashed-out at common price."

TGP understood the, "desire to modify the cashout regime to encourage additional demand-side response and thereby limit the duration and extent of a National Gas Supply Emergency (NGSE)".

SGD agreed with E.ON that, "pragmatic options should be pursued to ensure efficiency in the industry and to ensure that efforts can be focused on realistic approaches to improving demand side response."

Three respondents (GDF, SP and STUK) expressed the view that the prevailing SAP represented a 'fair market value for gas". GDF considered that the, "use of the prevailing System Average Price on the day is appropriate to provide a strong incentive for Users to balance in the event of an emergency and should help to prevent an escalation of a Gas Deficit Emergency." SP believed the Proposal sought to introduce an emergency cashout price that, "works better than the existing arrangements and avoids the artificiality of a 30-day period to calculate the price." STUK supports the view that the prevailing SAP is a fair market value for the gas, and would provide the appropriate incentives on Users to attempt to balance their positions under difficult circumstances.

SGD noted that it did not, "consider, nor have we seen any evidence to support, the contention that shippers' activities are based on expectations of emergencies being declared. Instead, shippers will want to ensure that they are not exposed to high cash-out prices which can occur with no risk of an emergency and, if supplies are tight, we would expect that all shippers are well aware of this given the current high forward prices for the upcoming winter."

EDF did not believe that, "the ideal level or type of cashout prices in an emergency has been properly identified. EDF noted that, "Ofgem has stated that 30 days average SAP as a cashout price in an emergency incentivises shippers to go short as it is likely to be a lower price than market prices in an emergency. However, we believe that many shippers, and more precisely offshore shippers will be incentivised to flow all or as much gas as they can onto the system to avert an emergency as they will not want only 30 days average SAP for their gas."

EDF considered that this Proposal was, "a far simpler and more effective proposal compared to Transco's 0044 as it is a neutral cashout price, i.e. Shippers will be equally incentivised to flow gas onto the system and help avoid an emergency. The merits of a neutral cashout price in an emergency was one of the reasons why a single price was proposed at the start of Network Code in 1996 and why a better solution has never been developed or adopted."

SSE agreed with the view of the proposer that the introduction of high emergency Cashout prices could, "create a perverse incentive for parties to hold more gas in reserve for themselves in the lead up to an emergency, because of the fear of a penal cashout, rather than encouraging them to "help" either by releasing excess gas to the market or by placing demand side bids on the OCM. This could actually exacerbate the development of the situation and lead to the declaration of an emergency."

SSE reminded that prevailing Emergency arrangements, "oblige Users under UNC, licence and law (GS(M)R) to cooperate with requests by the NEC/any Transporter to maximise flows on to the system and to reduce/cease offtake of gas from the system at relevant offtakes."

SSE stated that, "once a GDE has been declared, Users are subject to "command and control" management by NEC/Transporters. In addition, the provisions of TPD Section C are suspended, except where required for communication between Transco NTS (arguably all Transporters) and Users. At this stage Users will be unable to execute NBP trades. Physically, gas flows onto and offtakes from the system are subject to command and control by the NEC/relevant Transporter." SGD considered that this means, "the User's ability to balance its portfolio will be extremely limited. Furthermore, Users' portfolios in any event will be subject to significant uncertainty in terms of demand and supply during the emergency. It stands to reason therefore that to continue to impose "incentives" on Users to balance would introduce an unmanageable risk when there is no market to utilise. It is our understanding that this reality is implicitly recognised by the adoption of the "neutral" single cashout price which underpins Section Q and has been in place for many years."

SSE continues to believe that, "the most appropriate approach to the derivation of emergency cashout prices is to maintain the concept of the single "neutral" price for imbalances whether a shipper is long or short. This approach would seem to be in keeping with the principles expounded by CORWG, namely that cash-out prices in an emergency should be hold a party neutral. We note that under the UNC there is an appeals process for parties who are long that believe, ex-post, that the emergency cashout price would not adequately compensate them for the costs they incurred delivering gas to the system."

SSE did not consider that, "to move to a prevailing SAP would incentivise the "right" behaviour as it would not take account of the User's inability to balance once a GDE has been declared."

CIA noted that, "As the gas market has not experienced an emergency under the current baseline, it is difficult to determine how quickly a Gas Deficit Emergency could be entered into and we note that different stages of an emergency can be entered into simultaneously. Bearing this in mind there may be little time for consumers and/or shippers, or prices to respond. We are in support of moving away from 30-day average System Average Price (SAP), to a cash-out that would provide stronger signals for Shippers to balance. We are aware that Shippers can refine their position through OTC trades during Stage 2, when the OCM has been suspended."

CIA expressed support for both this Proposal and MP0044, but noted that, "they do little to amend the cash-out rules under Stage 1, and therefore the incentives already in place regarding emergencies. We do not see these modifications as the route to ensuring that the market does not enter into an emergency. They represent a small change to the existing arrangements."

In respect of the changes proposed within the Modification, CSL stated that, "It is probable such changes (if implemented) would distort forward traded markets as a significant quantity of gas has already traded on the basis of the existing emergency cash out rules and shippers impressions of the likelihood of a GSE. We believe sufficient disincentive against exacerbating an emergency to seek the protection of neutral cash out rules exist through inter alia shipper licences, GSMR and general competition law and that a rushed assessment of new rules 5 weeks before the start of Autumn is not an efficient or effective process."

EON considered that, "Setting the emergency cash-out price at the prevailing SAP strikes the appropriate balance between a neutral cash-out price and a penal emergency cash-out price of SMP Buy, for Users which are short of gas. Where an emergency is progressive, the SAP will be appropriately high to provide additional incentive on Users to avoid entering into a GDE. Where the emergency is rapid, such as a terminal failure, Users do not have sufficient time to respond to avoid an emergency, the SAP is a more appropriate price than SMP Buy as Users should not be hit with a penal Buy Price for something which they have been unable to avoid."

EON Stated that, "Modification proposal 042 ensures that Users are not exposed to extremes and the unmanageable risk created by an SMP Buy price, but at the same time, suitably incentivises Users to take action to prevent a GDE from occurring."

TNTS noted the comments made by Ofgem in respect of the "collective insurance" provided by the current arrangements and the conclusion that this has the potential to distort effective competition "as it reduces the incentives for shippers to contract ex ante for additional gas or demand side response, and results in cross subsidy between shippers". TNTS considered that, "In our opinion implementation of this Proposal would be likely to increase the cash-out price under emergency conditions when compared with the current arrangements. This would mitigate against these potential distortions. "

GDF stated that, "The use of the prevailing System Average Price on the day is appropriate to provide a strong incentive for Users to balance in the event of an emergency and should help to prevent an escalation of a Gas Deficit Emergency."

A Gas Deficit Emergency (GDE) or potential GDE would result from forecast demand being in excess of available supplies and hence by definition may require a response based on demand-side reduction. While the prevailing SAP may be a "fair market value for gas" it would have to represent a fair market value for demand reduction to incentivise the behaviour that might lead to appropriate actions, through which a GDE might be avoided, or its duration or extent reduced.

Small Volumes

TGP considered that, "as suggested in proposal 42, the application of the daily SAP immediately preceding the commencement of the emergency represents a pragmatic compromise between the need to appropriately incentivise users to balance and to ensure that the cashout price is not penal. This is likely to be the case since one would expect this SAP to incorporate the events/information leading up to the emergency and by definition be less likely to be skewed by the acceptance of small volumes at extreme prices."

In respect of the proposed introduction of a single emergency cashout price set at the prevailing SAP, GDF considered that, "An effective incentive to balance is achieved with this approach without exposing Users to the unquantifiable risk of SMP buy price which could be set by a single extreme outlying offer with small volume and high price (as recently experienced in the electricity market). The daily System Average Price is a widely recognised published indicator; which adds to clarity."

SGD noted that it did not, "consider, nor have we seen any evidence to support, the contention that shippers' activities are based on expectations of emergencies being declared. Instead, shippers will want to ensure that they are not exposed to high cash-out prices which can occur with no risk of an emergency and, if supplies are tight, we would expect that all shippers are well aware of this given the current high forward prices for the upcoming winter."

SSE stated that, "Where an emergency is rapid, we completely agree with the proposer that to set the emergency cashout price at the prevailing SMP Buy could unfairly penalise Users. To do so could result in small trades setting a penal cashout price which could potentially send companies out of business."

AEP shared the concerns of some participants that, "a SMP BUY price could be set by a single bid possibly for a small volume at an extreme price. In a rapidly developing emergency the prevailing SAP would be more reflective of the true market value of gas than the SMP BUY, and would therefore strike an appropriate balance between providing stronger incentives to balance but avoiding a penal cashout price set by a single outlier trade. Indeed in the absence of an outlier bid, if there was any kind of consensus in the market as to the price of gas and significant volumes were traded at this price then SAP and SMP BUY would tend to be similar. In addition under the current claims process any shipper who has a long position and does not consider that the emergency cashout price has adequately compensated them for the costs of sourcing additional gas may submit a claim for the additional costs."

CSL considered that, "The risk of Transco setting a very high SMPb against a small volume of gas is mitigated through this proposal. Whilst recognising a small volume trigger may be addressed through amending the 'normal' cash out rules, such changes would have a far greater impact on shippers positions for this winter than amendments to the emergency rules."

Transco NTS noted that the views expressed in MP0044 were relevant to consideration of this Proposal. In that Proposal it stated, "Prior to entering an emergency period, Transco NTS will accept all economic and efficient offers on the OCM. In assessing the economics and efficiencies of a particular offer, Transco NTS will consider whether the quantity of that action will have a discernible positive impact on the supply/demand position. Thus, a small quantity, high price action may well not be taken, as it would not aid in the overall supply/demand balance position. If there were a number of small quantity actions that could be taken that, in aggregate, would aid the overall Supply & Demand balance position, then Transco NTS would accept them. In these circumstances, it is Transco NTS's view that, as the highest priced action has helped to resolve the supply/demand imbalance, it is appropriate for it to set the cash out price. In all circumstances, including emergency circumstances, it is essential that cash-out prices provide Users with strong incentives to balance their positions. During stages 2 and 3 of an emergency, Users will be able to enter into OTC trades and submit nominations to Transco NTS, and therefore cash-out prices at these times not only provide incentives for Users to undertake such trades in order to balance their positions, but also incentives to ensure that gas is physically delivered. This is distinct from the electricity arrangements where Gate Closure prevents market participants from trading with each other, (as the sole counterparty is the system operator) and there are alternative mechanisms and obligations in place to ensure physical delivery. As such we believe that a 'pure marginal' SMP Buy price is required during a GDE to ensure that no financial benefit can be derived from undertaking a trade at one price, not physically delivering, and being cashed out at a discounted price due to any aggregation at the margin. We note Ofgem's view that the issues around small volumes of gas setting the cash out price are less significant that they are in electricity due to the longer balancing period. Additionally we believe that the nature (i.e. the number of actions and the timescales associated with delivery) of gas balancing actions minimise the risks of a small volume balancing action inappropriately setting the cash out price."

If Users have access to commercial 'interruption' then it would only be economic to action such 'interruption' if the resulting reduced cash-out exposure were greater than the cost of the action, notwithstanding any other reasons a User may have for triggering commercial interruption. As a Gas Deficit Emergency (GDE) or potential GDE would result from forecast demand being in excess of available supplies, and hence, by definition, might require a response based on demand-side reduction, the Cash-out price associated with 'short' Users would need to be in excess of the unit cost of demand response to incentivise the behaviour that might lead to appropriate actions, through which a GDE might be avoided, or its duration or extent reduced. The potential for Transco NTS to take appropriate demand-side actions that might move the cash-out price away from 'gas' costs towards 'demand-reduction' costs must remain if demand response is to have a role within the gas market outside of a GDE.

Rapid onset of a GDE

SGD stated that it was, "also in accordance with E.ON's view that GDEs may be rapid and not give shippers sufficient time to react. Setting a penal cash-out price in these circumstances only reduces the commercial attractiveness of entering or remaining in the gas supply market. Any negative impact of such a proposal will be picked up by consumers through higher prices and/or reduced competition."

In respect of the cashout element of this proposal and modification proposal 0044, AEP stated that it was, "disappointed that Ofgem was dismissive of concerns raised over emergencies developing over different timescales. We expect Ofgem to explain more fully why it is unwilling to consider scenarios where an emergency develops rapidly."

If a Gas Deficit Emergency develops so quickly that the NEC calls stages 1,2&3 at the same time then the market would be suspended and any subsequently high priced trades could not be offered, accepted and factored into the cash-out price determination. If an emergency is progressive then there is scope for increased cash-out prices but there may also be more time to mitigate the risk of cash-out exposure.

Prevailing Claims process

EON understood that in respect of Users not being appropriately incentivised to sell gas in an emergency, "if any User feels that they have suffered financial loss by reason of being paid only the relevant cash-out price for gas delivered to the System, a User can submit a claim to Transco to be paid at a higher price."

Interaction with Interconnectors

SGD consider that, "E.ON may have underplayed the potential for its proposal to address concerns regarding Interconnector flows." SGD stated that it had, "not considered that the emergency cash out prices needed review except potentially in respect of ensuring continuing supply from the continent. While it is the case that cold temperatures and high prices can coincide in Britain and on the continent, the current emergency cash out price is likely to be below the market price on the continent in cold conditions. This means that even if gas is available, it may not be financially attractive to export it to Britain. The cooperation of the interconnector operator can not do anything to ensure that gas arrives at the flange to be imported into Britain. A cash out price based on what would be expected to be market-reflective conditions before an emergency is declared is likely to encourage gas into Britain."

SSE agreed with the view expressed by the proposer that, "it is highly unlikely that any change to emergency cashout prices would provide any greater incentive for gas to be delivered to GB from the continent or via LNG imports. The experience earlier this year leads us to conclude that the physical flow of gas is subject to other influences outside the remit of UNC. We believe that concerns in this area are more appropriately addressed by for example changes to European market arrangements and security of supply obligations or via the interconnector agreements."

Whether it produces a physical change or not, if the prevailing SAP is greater than the 30 day average SAP then the implementation of this Proposal would create a greater financial incentive to flow gas to the UK compared with the prevailing arrangements.

Demand side response

GDF considered that, "Supply-side response and appropriate pricing arrangements are important to this but also critical to this debate is demand side response, which should be considered as an integral part of pre-emergency arrangements. It is important to stress that all commercial demand side options should be fully developed by industry participants and accepted by Gas Transporters ahead of a potentially tight supply/demand situation. Demand side offerings should be exhausted before emergency conditions are declared and hence the requirement to change the current emergency cash-out prices became less necessary."

If demand side options are fully developed by industry participants then there is already a route for them to be taken as residual System Balancing Actions. Demand response can already be offered via the OCM and, as Transco NTS has publicly stated that the OCM is its primary residual balancing tool, there is the potential for demand side offers to be taken as System balancing actions. This would allow such actions to feed into the cash-out price determination methodology and hence influence SAP and System Marginal Prices.

12. The extent to which 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

No such requirements have been identified by the Proposer

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

No programme for works has been identified by the Proposer.

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

The Proposer has suggested an implementation date of 1 September 2005.

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

No such implications have been identified by the Proposer.

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

At the Modification Panel meeting held on 1 September 2005, of the nine Voting Members present, capable of casting ten votes, eight votes were cast in favour of implementing this Modification Proposal. Therefore the Panel recommended implementation of this Proposal.

18. Transporter's Proposal

This Modification Report contains the Transporter's proposal to modify the Code and the Transporter now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

UNIFORM NETWORK CODE - TRANSPORTATION PRINCIPAL DOCUMENT

SECTION Q - EMERGENCIES

Amend paragraph 4.2.3 to read as follows:

"4.2.3 For the purposes of this paragraph 4.2 the "**relevant price**" is the value of the ~~arithmetic mean of the~~ System Average Price~~s~~ determined under Section F1.2.1 or F1.2.2 but by reference to the ~~30 Days preceding the~~ Day on which the Network Code Gas Supply Emergency Gas Deficit Emergency started."

Subject Matter Expert sign off:

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

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

Tim Davis
Chief Executive, Joint Office of Gas Transporters

Signature:

Date :