Our Ref: ab119-05vhl

The Joint Office, Relevant Gas
Transporters and other interested
parties

16th September 2005

Dear Colleague

Uniform Network Code modification proposal 042 "Revision of the Emergency Cash-out price" and Uniform Network Code modification proposal 044 "Revised Emergency Cash-out & Curtailment Arrangements"

Ofgem[1] has considered the issues raised in the modification reports in respect of modification proposal 042 "Revision of the Emergency Cash-out price" and modification proposal 044 "Revised Emergency Cash-out & Curtailment Arrangements", and having regard to the principal objective and statutory duties of the Authority[2], has decided to direct the relevant gas transporters to implement modification proposal 044 and not to implement modification proposal 042.

Ofgem considers that both modification proposal 042 and modification proposal 044 would better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11 of the relevant gas transporters'[3] licences as compared with the existing provisions of the UNC. However, Ofgem further considers that modification proposal 044 will better facilitate these objectives as compared with modification proposal 042.

In this letter, Ofgem:

i. explains the background to the modification proposals (pages 2-6);
ii. summarises the proposals (pages 6-7);
iii. summarises the views of the respondents and the Panel (pages 7-17); and
iv. sets out its views on the proposal and gives reasons for its decision (pages 17-26).

[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] Set out in Section 4AA of the Gas Act 1986, as amended.
[3] On 1 May 2005, Transco hived down 4 of its Distribution Networks into four wholly Transco owned subsidiary companies in preparation for the sale of these DNs (scheduled for 1 June 2005). On 1 June 2005 the share sale was completed, and the relevant gas transporters are Transco's RDN and NTS businesses and the buyers of the DNs.

Background to the proposal

Current cash out arrangements in normal market operation

The current gas balancing arrangements are designed to provide shippers with strong commercial incentives to balance their inputs to and offtakes from the National Transmission System (NTS) by the end of the gas day[4]. Under normal circumstances, if a shipper is out of balance at the end of the day, any imbalance volume is cashed-out at prices determined by trades on the On-the-day Commodity Market (OCM). Different imbalance prices apply depending on whether the shipper is short gas or long gas[5]. A shipper that is short gas pays the system marginal buy price (SMP Buy) which is the highest price of any trade to which Transco NTS is a party on the OCM, excluding any trades that it takes for locational reasons[6]. A shipper that is long gas is paid the system marginal sell price (SMP Sell) which is the lowest price of any trade to which Transco NTS is a party on the OCM, excluding any trades that it takes for locational reasons[7]. Cash out prices are therefore designed to reflect the costs that Transco NTS incurs in buying and selling gas to balance the system each day.

In the event of a gas supply emergency, different cash out arrangements (as set out below) apply.

Current gas supply emergency cash out arrangements

Transco NTS, as Network Emergency Co-ordinator (NEC)[8], has specified a Safety Case[9], which sets out its procedures to deal with a gas supply emergency. The NEC Safety Case, in conjunction with the Gas Safety (Management) Regulations (GS(M)R) (1996), details the arrangements for co-ordinating the actions to be taken to prevent a supply emergency occurring or continuing. It includes an assessment of network risk and identifies two situations that would result in a Network Gas Supply Emergency (NGSE). The first is where there are insufficient gas supplies available to the NTS to meet demand. The second is where there is a critical transportation constraint in either the NTS or in a distribution network (DN).

When Transco NTS identifies a supply shortfall that is unable to be addressed through the normal commercial arrangements, it will ask the NEC to declare an emergency situation. The NEC would then invoke all or part of the following five-step procedure as appropriate:

- **Stage 1 – notice of impending emergency**. This indicates that there is a potential gas emergency, where the information available to the NEC at Stage 1 indicates that there is sufficient time and sufficient gas available, for the primary system to be rebalanced without recourse to Stage 2. This would include maximising the use of linepack, storage and interruption: normal cash out arrangements apply during this stage.

- **Stage 2 – declaration of emergency**. At this stage the OCM is suspended and the primary transporter is instructed to carry out the measures set out in the emergency arrangements. After the OCM has been suspended, a new cash out price needs to be

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[4] That is, in each 24 hour period beginning at 6am each day.
[5] See section F.1.2 of the UNC.
[6] Alternatively, SMP Buy is set at the system average price (SAP) of gas traded on the OCM plus a fixed value set at 0.0287p/kWh (which is based on the price for injecting gas into the Hornsea storage site in 2000) if this is greater than the highest priced Transco NTS trade. Note that if Transco NTS does not purchase any gas, SMP Buy defaults to this price.
[7] Alternatively, SMP Sell is set at SAP minus a fixed value set at 0.0324p/kWh (which is based on the price for delivering gas from the Hornsea storage site in 2000) if this is lower than the lowest priced Transco NTS trade. As for SMP Buy, the SAP related price is the default SMP Sell price if Transco NTS does not sell any gas.
[8] The named role for the NEC is the Director of Operations and Trading of Transco NTS.
[9] As approved by the Health and Safety Executive (HSE).

established. Under the current provisions of the UNC, the existing dual cash out price (as outlined above) is replaced by a single price during this stage[10].

Currently this is calculated as the average of the System Average Price (SAP) for the 30 days immediately preceding the suspension of the OCM. Therefore, short shippers pay for any shortfall at 30 day average SAP, while long shippers are paid for any surplus at 30 day average SAP;

- **Stage 3 – firm load shedding**. The affected transporter makes direct or indirect contact with firm end-users and instructs them to stop or reduce their offtakes of gas. Firm load shedding is divided into three tranches of increasing severity and effect. The three tranches are:

    - very large end-users (VLDMC) (those taking more than 50 million therms per annum (tpa))
    - large end-users (those taking between 25,000 tpa and 50 mtpa)
    - end-users taking less than 25,000 tpa

    Firm load shedding will be invoked in the order shown above. It is at Stage 3 that exports of gas through interconnectors can be curtailed;

- **Stage 4 – system isolation**. The available gas would be allocated to secondary systems supplying domestic end-users;

- **Stage 5 – restoration**. Normal arrangements are restored.

The actions that Transco NTS and the NEC would take are set out in the NEC Safety Case.

Previous consideration of the appropriateness of the current arrangements

This section summarises briefly industry discussion and previous modification proposals in respect of the emergency cash out arrangements.

Gas Industry Emergency Committee (GIEC)

The GIEC (and subsequently the Gas and Electricity Industry Emergency Committee (GEIEC)) has considered the appropriateness of the current emergency cash out arrangements. Areas identified for consideration included the effectiveness of incentives provided by a neutral emergency cash out price to encourage gas onto the system prior to the declaration of an emergency at Stage 2 and/or to reduce gas demand and the potential for perverse incentives not to alleviate or avoid an emergency occurring.

A number of modification proposals to Transco's network code have previously been raised to try to rectify the perceived problems with the prevailing emergency cash out arrangements.

Previous modification proposals

Previous modification proposals to Transco's network code in relation to the emergency cash out arrangements include:

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[10] See section Q.4.2 of the UNC.

- modification proposal 0294 "Change to Cash-Out following an Emergency";
- modification proposal 0502 "Changes to Commercial Arrangements in the Event of a Gas Supply Emergency";
- modification proposal 0568 "Changes to Commercial Arrangements in the Event of a Network Gas Supply Emergency";
- modification proposal 0582 "Changes to Commercial Arrangements for a Network Gas Supply Emergency"; and
- modification proposal 0635 "Changes in Gas Supply Emergency Arrangements".

Details of these historic network code modification proposals are expected to be made available on the Gas Transporters Information Service Site (formally known as Nemisys) https://gtis.gasgovernance.com shortly. In addition, a more recent modification proposal to the UNC in relation to the emergency gas cash out arrangements (modification proposal 021 "Revision of the Emergency Cash-Out Arrangements") is discussed below.

Cash out review

In response to the various issues raised in the gas market in relation to the existing commercial arrangements in the event of an emergency situation, and in response to similar concerns raised through various modification proposals in the electricity market[11], on 1 March 2004 Ofgem published a letter setting out its intention to undertake a review of the cash out arrangements currently in place in both markets.

On 17 May 2004, Ofgem published a consultation document which identified those areas of the gas and electricity arrangements which it considered to be most relevant when addressing the incentives to balance and security of supply.

In September 2004 Ofgem established a cash out review working group (CORWG) the purpose of which was to assess, holistically, the issues relating to the electricity and gas cash out arrangements based on the consideration of a number of primary and secondary objectives[12]. The issues to be considered and the scope of the assessment were based on the May 2004 consultation document, with an additional call to the group by Ofgem for an examination and assessment of the cash out arrangements in emergency situations.

The main focus of the group in relation to the gas market was the emergency cash out arrangements. Two of the key areas considered by the CORWG were:

- the need to ensure that there are appropriate incentives to encourage users to take appropriate actions through which a gas deficit emergency (GDE) might be avoided, or, its duration or extent reduced; and
- whether the 30 day average SAP was high enough to incentivise price sensitive gas to flow to the UK when a GDE has been declared.

[11] These issues and concerns are raised in the network code modification proposals 0294, 0502, 0568, 0582 and 0635 referred to above. In the context of the electricity arrangements, similar issues are raised in the modification proposals P135 ("Marginal System Buy Price During Periods of Demand Reduction") and P138 ("Contingency arrangements in relation to the implementation of Demand Control measures pursuant to Grid Code OC6").

[12] The CORWG would primarily explore whether the cash out arrangements in electricity and gas: provide appropriate commercial incentives for market participants to balance their own positions and therefore deliver security of supply; and reflect the costs incurred by the relevant system operator when undertaking energy balancing actions as residual balancer and therefore provide appropriate signals to market participants as to the costs of supplying balancing energy in the relevant balancing period.

The CORWG met to discuss issues in relation to emergency gas cash out on 7 March 2005. The CORWG papers are available on Ofgem's website www.ofgem.gov.uk. The CORWG has subsequently been reconvened having met once again on 6 September 2005 and analysis of any perceived issues associated with the existing gas and electricity cash out arrangements will be conducted over the coming months.

National Grid's (NG) preliminary winter outlook report – 2005/06

NG published its preliminary winter outlook report (WOR)[13] on 31 May 2005, which stated that NG supported Ofgem's view that the current emergency cash out arrangements may not appropriately incentivise users to take all actions that might avoid a GDE being triggered. NG outlined that it intended to raise a modification proposal in this area.

In its covering letter[14] to NG's WOR, Ofgem stated that it considers that the current emergency gas cash out arrangements do not properly reinforce the system of incentives designed to ensure that market participants contract for sufficient gas to meet demand in severe winter conditions. Ofgem agreed with NG that the gas emergency cash out arrangements are critical to the efficient functioning of the market and therefore to security of supply.

UNC modification proposal 021

UNC modification proposal 021 "Revision of the Emergency Cash-Out Arrangements" was subsequently raised by Transco NTS on 1 June 2005 and was granted Urgent status by Ofgem on 2 June 2005[15].

Transco NTS raised this modification proposal to address concerns that the current arrangements would not provide sufficient incentives on shippers to take all actions possible to avoid entering into an emergency or to minimise the duration of an emergency. It considered that the current arrangements could have an adverse impact on price sensitive gas because the 30 day average SAP would not be high enough to provide effective commercial incentives for gas to flow from Europe via the interconnector and to be imported through the Grain LNG terminal during stage 2 of an emergency when the market has been suspended.

In summary, this modification proposal sought to address two elements of the gas emergency cash out arrangements:

1) To replace the current arrangements where shippers face a single cash out price whether they are long or short (set at the 30 day average SAP) with a dual price regime at the point of market suspension. Under the proposal:

   a) the emergency cash out buy price will be set to the prevailing SMP Buy price prior to the commencement of an emergency; and
   b) the emergency cash out sell price will be set to the prevailing SAP prior to the commencement of an emergency.

2) To introduce a new Emergency Interruption Volume (EIV) title trade and associated 'trade' payment. The EIV will be an approximation of the volume of gas that would have been taken off by the relevant offtake site had there not been interruption. The method of

[13] 'NGT's preliminary winter outlook report – 2005/06', May 2005.
[14] 'Open letter – NGT's preliminary winter outlook report – 2005/06', May 2005.
[15] Ofgem's decision letter following Transco NTS's request for urgent status can be found on the Gas Transporters Information Service Site (formally known as Nemisys) https://gtis.gasgovernance.com.

assessment for this volume would be the Offtake Profile Notification (OPN) with a number of alternatives, to be pre-determined, to be applied when OPNs are not available. The EIV will effectively be purchased by Transco NTS at the 30 day average SAP but also removed from the demand and supply flows of affected users thus leaving their imbalance positions unchanged.

Ofgem rejected modification proposal 021 on 29 July 2005 on procedural grounds based on serious concerns about the adequacy of the consultation process, as set out in Ofgem's decision[16]. In the decision letter, Ofgem stated that it considered that the issues that Transco NTS was attempting to address in raising the modification proposal were very important particularly for the coming winter and encouraged Transco NTS and other signatories to the UNC to consider whether further modifications in this area should be raised to allow these issues to be addressed ahead of the coming winter. In this light, Ofgem went on to highlight those elements of the modification proposal which it considered could potentially better facilitate the relevant objectives and those elements of the proposal which required more consideration.

The Modification Proposals

Modification Proposal 042

E.ON UK submitted modification proposal 042 "Revision of the Emergency Cash-Out price" on 3 August 2005 to which Ofgem granted Urgent status on 9 August 2005.

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.

Modification Proposal 044

Transco NTS submitted modification proposal 044 "Revised Emergency Cash-out & Curtailment Arrangements" on 9 August 2005 to which Ofgem granted Urgent status on 9 August 2005.

Modification proposal 044 was intended by Transco NTS as an alternative to modification proposal 021 including additional features and clarifications designed to address issues raised in the consultation and decision on modification proposal 021. In summary, modification proposal seeks to:

1) Amend the setting of the emergency cash-out prices from the prevailing single price of the 30 day average SAP to dual prices set at the point of market suspension:

   a) the cash out price for users with a negative Daily Imbalance will be set to the SMP Buy prevailing on the day the GDE commenced; and
   b) the cash out price for users with a positive Daily Imbalance will be set to the SAP prevailing on the day the GDE commenced.

2) introduce a new Emergency Curtailment Quantity (ECQ) title trade and associated 'trade' payment

[16] Ofgem's decision letter in relation to modification proposal 021 can be found on the Gas Transporters Information Service Site (formally known as Nemisys) https://gtis.gasgovernance.com.

The ECQ title trade seeks to assign the quantities of gas associated with emergency curtailment actions undertaken by Transco NTS in a GDE (including a Potential GDE) as a Trade Nomination between Transco NTS and each user:

- the ECQ would be calculated as the aggregate quantity of Emergency Curtailment occurring as a result of a potential or actual GDE at the relevant System Exit Points less any quantity of user commercial "interruption" at the same System Exit Points notified to the relevant Transporters prior to the Emergency Curtailment occurring; and
- for those occurrences of Emergency Curtailment in a GDE, users would receive payment based on the ECQ multiplied by a price determined as the 30 day average SAP prevailing at the commencement of the GDE.

Respondent's 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.[17]

Modification Proposal 042

Sixteen responses were received in relation to modification proposal 042. Of these responses ten respondents, including the proposer, expressed support for the proposal and one respondent offered qualified support and five respondents were against implementation of the modification proposal.

Respondents supporting the modification proposal

<u>Price</u>

The proposer was of the view that the current emergency cash out arrangements do not provide the most appropriate incentives on users to make suitable provisions to avoid entering into, or to reduce the duration of, a GDE. The proposer considered that setting the emergency cash out price to SAP on the day would provide appropriate incentives for shippers to balance their inputs and offtakes leading up to an emergency. The proposer also considered that the prevailing SAP would strike the appropriate balance between a neutral cash out price and SMP Buy, which they considered to be penal, especially for a rapid emergency situation as users would have insufficient time to respond to avoid an emergency.

The majority of respondents in support of the proposal and the respondent offering qualified support considered that in a rapid emergency the prevailing SAP would be more reflective of the true market value of gas than the 30 day average SAP and would provide an appropriate balance between providing stronger incentives and avoiding a potentially penal cash out price. One respondent considered that the use of prevailing SAP would provide sufficient incentives for users to balance and prevent an escalation of a GDE. This respondent went on to note that SAP was a widely recognised and published indicator, which would provide additional clarity. Several respondents further considered that any users that were long gas who did not consider that prevailing SAP provided them adequate compensation for selling their gas could submit a claim as part of the claims process.

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

De-minimis

Several respondents in support of the modification proposal considered SAP to be more appropriate than SMP Buy as it was less likely to be skewed by a small volume setting a high price. These respondents considered that the risk of a small volume of gas setting a high marginal price was mitigated through this proposal, stating that while 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. A further respondent considered that introducing SAP would mitigate any perverse incentives to "game" the market that a marginal and possibly extremely high price may encourage.

Price sensitive gas

The proposer did not consider that any proposal (such as modification proposal 044) which sought to amend the emergency cash out rules to incentivise price sensitive gas to flow to the UK during a GDE could have any significant effect on price sensitive gas. The proposer was of the view that long-term value on the continent from offering commitment to customers in ensuring their supplies were maintained, could see the interconnector exporting to the continent despite the possibility of financial gains in the UK, which the proposer stated had been demonstrated earlier this year.

Conversely, three respondents considered that the implementation of modification proposal 042 would incentivise gas flows from the continent to GB. One respondent in favour of the modification proposal noted that it did not consider that the emergency cash out arrangements needed review except potentially in respect of incentivising flows from the continent. This respondent was of the view that the current emergency cash out price would generally be lower than the market price on the continent in cold conditions and therefore a cash out price based on a price which reflects the market conditions, i.e. the prevailing SAP, would be likely to encourage gas to GB. In line with this view, another respondent noted that it supported Ofgem's view from the modification proposal 021 decision letter that paying shippers who were long SAP rather than 30 day average SAP would promote the economic and efficient operation of the system by encouraging price sensitive sources of gas such as the interconnector or LNG storage to flow into the GB market. Another respondent considered that from the perspective of attracting price sensitive gas to the UK it was mildly supportive of the intent of modification proposal 042.

Respondents against the proposal

Price

Respondents who were opposed to the implementation of the proposal considered that a move to the prevailing SAP would not sufficiently incentivise users to balance their positions in the lead up to an emergency being declared. One respondent noted that to continue to impose incentives on users to balance in an emergency situation would introduce an unmanageable risk as it was of the view that there would be no market in place to enable them to change their positions

Two respondents expressed concern that while a marginal price may not be appropriate in all circumstances, it was preferable to the proposed prevailing SAP. One respondent stated that, despite having some residual concerns that a marginal price may expose shippers to unmanageable risk in an emergency that develops rapidly, on balance it was preferable to the proposed SAP and current 30 day SAP, as it strengthens incentives on shippers to balance and offer demand side response. The other respondent noted that while they were supportive of the proposer's concerns that a GDE may be rapid and that, in such circumstances, a marginal emergency cash out price could mean that prices were extreme, the move to prevailing SAP could still create perverse incentives and have unintended consequences. For these reasons neither respondent could support the implementation of prevailing SAP as the emergency cash out price. Another respondent considered that a single SAP price would fail to incentivise users to balance.

One respondent noted that they did not agree with Ofgem's view that a single cash out price based on the average of the previous 30 days' SAP would not sufficiently incentivise shippers to flow extra gas in an emergency. This respondent did not consider that any shipper would purposely or commercially withhold gas as the consequences of the market being suspended or firm load shedding would be in no ones interest. The respondent was of the view that 30 day average SAP should remain in place given that it is clear and fair and the industry understands the associated risks.

Price sensitive gas

One respondent opposed to the implementation of the proposal considered that it was highly unlikely that any change to the emergency cash out prices would provide greater incentives for gas to be delivered from the continent or via LNG imports. This respondent noted that experience had shown these physical flows of gas were subject to other influences outside the UNC and therefore this area would be more appropriately addressed through changes to European market arrangements and security of supply obligation or via the interconnector agreements.

Process

Several respondents raised concerns regarding the process that had been followed in relation to this modification proposal. One respondent considered that it was inappropriate for UNC proposals which sought to address serious issues regarding the commercial incentives placed on users during an emergency to be granted urgent status as this could result in parties having insufficient time to consider properly the impacts of the changes.

Modification Proposal 044

Eighteen responses were received in relation to modification proposal 044. Of these responses two respondents, including the proposer expressed support for the proposal, four respondents offered qualified support and twelve respondents were not in favour of implementation of the proposal.

Respondents supporting the modification proposal

Price

The proposer was of the view that the current emergency cash out arrangements do not provide the most appropriate incentives on users to balance their portfolios to avoid entering into, or to minimise the duration or extent of, a Gas Supply Emergency. The proposer considered that the prevailing 30 day average SAP may have an adverse impact on the likelihood of price sensitive supplies continuing to be delivered in a potential or actual emergency. The proposer also considered that the existing emergency cash out arrangements generate little financial incentives to action demand side response as the financial exposure created by a short term position and a neutral cash out price set at 30 day average SAP would be expected to be less than the costs associated with the delivery of a quantity of demand side response that would balance a user's portfolio.

The proposer considered that any change to the cash out price applicable during a GDE should ensure that users would not have a financial incentive to withhold gas or demand side response from the system i.e. the cash out price for users with a positive daily imbalance should fairly reward those providing gas to the system to assist with the efficient management of the GDE. Similarly, the cash out price for users with a negative daily imbalance should reflect the marginal value of demand response, providing appropriate incentives for users to cover their short positions. The proposer considered that a single cash out price could not reflect both these values and hence a dual cash out price would be more appropriate. The proposer was also of the view that setting the cash out price for users who are long gas at the prevailing SAP, and for users who are short gas at the prevailing SMP Buy price would better align the cash out prices applicable during a GDE to those market prices prevailing at the start of an emergency.

The one respondent other than the proposer who was in favour of the implementation of the proposal stated that they were in support of moving away from 30 day average SAP to a cash out price that would provide stronger signals for shippers to balance. Two respondents who offered qualified support for the proposal considered that introducing SMP Buy was preferable to 30 day average SAP and prevailing SAP. One of those respondents considered that introducing SMP Buy would strengthen the incentives on shippers to balance their positions and offer demand side response. However, this respondent went on to note that they still had concerns that using a marginal price for cashing out negative imbalances could expose shippers to unmanageable risk in the event of a rapid emergency.

De minimis

One respondent noted that the proposal suggested a single marginal action could set the emergency price, but that Transco NTS had stated that "a small high price action may well not be taken if it would not aid the overall supply/demand position". This respondent was of the view that such a statement from Transco NTS was an important statement of policy and should be included in Transco NTS's procurement guidelines and System Management Principles Statement to avoid any conflicting messages to industry. Similarly, another respondent noted it was their understanding that Transco NTS would take "all operationally suitable" offers irrespective of price, but again this appeared to be in conflict with another statement made by Transco NTS that some trades may not be taken if they were to set a price much higher than the prevailing SMP Buy price. This respondent considered that further clarity was required, particularly given the importance of demand side response this winter, as Transco NTS's statement seemed to suggest that even if demand side offers were placed on the OCM, they may not be taken.

ECQ

The proposer considered that the aim of the modification proposal would be to create an environment where Emergency Curtailment can be avoided and that this would be aided by the ECQ methodology. The proposer noted the concerns of the industry regarding the increased levels of complexity associated with the ECQ methodology but considered that transporters could use the existing systems and data to produce the required estimates for the ECQ. The proposer also highlighted that if any user did consider that the ECQ value had been miscalculated, it could take this dispute to the claims process. The proposer also noted that since raising this modification proposal, numerous explanatory and supporting notes had been supplied to the industry.

The one respondent offering unqualified support of this modification proposal other than the proposer considered that it was important that in an emergency a shipper was left neutral to the impact of Emergency Curtailment or firm load shedding. This respondent welcomed that under the proposal, the ECQ would include firm loads. One of the respondents offering qualified support also noted this point and considered that this could lead to a greater level of demand side response earlier in an emergency. Another respondent considered that the 30 day average SAP payment for the Transco NTS interrupted sites would provide better incentives on sites to self interrupt. One respondent supporting the modification and a respondent offering qualified support also supported the introduction of a disputes process for the ECQ. The respondent offering qualified support considered that the disputes process should help to offset some of the commercial risks that were created by modification proposal 021 as long as the process was managed sensitively.

ECQ methodology

Two of the respondents offering qualified support considered that there would be merit in putting the methodology for calculating the ECQ into the UNC. One of these respondents stated that it still failed to understand how the ECQ would be calculated for sites for which within day load information is unavailable. This respondent further considered that, dependent on the Authority's decision, Transco NTS should commit to raising a non-urgent modification as soon as possible to develop a robust methodology for calculating the ECQ. This respondent considered that if the ECQ methodology was not in the UNC, a claims reviewer would be unable to determine the basis of such a claim.

P70 forms[18]

Two of the respondents offering qualified support for the implementation of the modification proposal expressed concern regarding the use of the P70 forms. These respondents considered that the submission of firm P70 forms may not provide sufficiently clear information in the run up to an emergency. These respondents pointed out that these firm P70 forms would be used for the first time in an emergency and that this could deflect resources from the more important issue of managing the physical balance of the system. These respondents also noted that the new arrangements would need to be thoroughly tested before being called upon in an emergency situation. One of these respondents was concerned that due to the timing of the implementation of the proposal (if approved), shippers would be unable to reflect the new ECQ arrangements in commercial contracts. This respondent also considered that the calculation of the ECQ should be carried out by Transco NTS, with the distribution networks providing the information on the P70 forms. This respondent was of the view that the ECQ could lead to a large number of disputes and it considered that this would be largely a reconciliation of energy matter and therefore best managed by Transco NTS.

One of the respondents also considered that it would be possible for a shipper to submit both P70 and firm P70 forms for sites that do not provide OPNs up to the declaration of an emergency. Under this scenario, the demand side response of these sites may not be taken into account by the system operator who would base its decision on the Terminal Flow Notifications and the OPNs. This respondent considered that due to the high cash out price, there could be

[18] The submission of a P70 form is intended to provide a clear indication to the Transporter of a user's instruction to the end consumer to stop taking gas at an offtake.

considerable scope for shippers to dispute the validity of the decision to declare an emergency, where the shippers consider that their demand reduction would have been enough to avoid an emergency situation.

This respondent also considered that it would be better to use closed-out energy values, which already have calorific value factored into the offtake volumes and are known to shippers. This respondent was also of the view that using D-1 as a proxy for the ECQ volume would not be reflective of the gas offtaken on the day. This respondent was concerned that in the event of a long prolonged winter, high levels of unnecessary shipper curtailment could lead to reduction in throughput and consequentially a reduction in transportation revenue.

Respondents against the proposal

<u>Price</u>

Two respondents stated that they were supportive of the principle to establish strong incentives on users to avoid entering into an emergency situation, but considered that this proposal did not recognise the potential for the prior emergency incentives to become penal once an emergency has been declared and therefore that the cash out prices would not be reflective of the market value of gas. One of these respondents considered that the current 30 day average SAP already provided sufficient incentives to flow gas onto the system to avoid an emergency because the relevant shipper would not want to receive 30 day average SAP for the gas. This respondent was of the view that no shipper would purposefully withhold gas from the system. Another respondent was of the view that prevailing SAP would be a more appropriate price when there is a rapid emergency. A further respondent considered that the SMP Buy price could create perverse incentives and lead to unintended consequences which have not been properly thought through. Two respondents also considered that users who feel that they have suffered financial loss could submit a claim to Transco NTS.

One respondent considered that this modification proposal could exacerbate an emergency and enable different users to be able to manipulate the system. This respondent also considered that this proposal would adversely affect smaller shippers who could incur large losses or bankruptcy. As an example, this respondent noted that shippers who have little or no offshore supplies would be limited in the amount of response they could make in an emergency, and also how effective they could be in balancing their position on the day, particularly when an emergency is rapid and runs into stage 2 or 3 where the market is suspended. The proposal would therefore adversely affect smaller shippers who rely wholly on the market for their supplies. Another respondent referred to a paper by Professor Stephen Littlechild which stated that the introduction of a dual cash out regime introduces a bias against smaller suppliers and therefore, this respondent was of the view that this proposal would discriminate against smaller suppliers.

One respondent who offered qualified support to the proposal considered, however, that in a rapid emergency the prevailing SAP would be more reflective of the true market value than the SMP Buy and would therefore strike an appropriate balance between providing stronger incentives to balance while avoiding a penal cash out price set by an outlier bid. This respondent went on to note that in the absence of an outlier bid (e.g. a particularly low OCM trade price), prevailing SAP and SMP Buy would tend to be similar. This respondent went on to express disappointment that Ofgem was dismissive of concerns raised over emergencies developing over different timescales and hence of the impact that SMP Buy pricing could have in a sudden emergency. This respondent considered that Ofgem should explain why it was unwilling to consider scenarios where an emergency develops rapidly.

One respondent offering qualified support considered that by setting the SMP sell price to prevailing SAP, it should, all things being equal, encourage shippers to overflow against their portfolio position. However, this respondent considered that it would be unwise to introduce a marginal price mechanism without introducing a strong framework for controlling trigger conditions, noting that Transco NTS would need to justify that the marginal price was economically and efficiently set e.g. is the marginal price set by the last LNG therm. Further, this respondent considered that an advantage of neutral cash out price would be that it allows the decision by Transco NTS to invoke an emergency to be free of other influence. This respondent also considered that the key to the emergency cash out mechanism was attracting price sensitive load within the European market. This respondent was also of the view that consideration should be given to a frozen cash out mechanism which would provide the necessary dynamic qualities associated with a protracted GDE.

One respondent expressed the view that a marginal buy price would create incentives to "game" the market, which would increase the possibility of an extreme cash out price being set. Another respondent considered that the possibility of being exposed to an extremely high SMP Buy price could encourage users to withhold gas from the system to avoid being short, and to avoid the possibility of user termination.

One respondent considered that the introduction of the SMP Buy price to be imposed on users in a short imbalance position was in line with the "polluter pays" concept, a recurring theme in many areas of the UNC. This respondent noted that if adopted appropriately, the SMP Buy price should be enough to lessen the need for emergency curtailment.

De minimis

The majority of respondents who opposed the proposal expressed concern that a small volume trade could set a high marginal price, particularly when emergencies are rapid and users do not have sufficient time or the ability to balance their positions. One respondent who was unclear on how the proposal would deal with de minimis balancing actions suggested that de minimis bids less than 50,000 therms should not feed into cash out prices. Several respondents made reference to a similar proposal in the electricity industry, BSC Modification Proposal P135[19], which was rejected on the basis that it would permit a small volume of energy to set the price. One respondent noted that it would be concerned if the Modification Proposal P135 conclusion was not felt to be substantial enough an issue in the gas market to cause this modification proposal to be rejected. Another respondent noted that a single cash out price would be more equitable and consistent with Ofgem's response to Modification Proposal P135 where a neutral price was considered to be appropriate when the market is suspended.

Demand side response

One respondent considered that modification proposal 044 failed to take into account the findings of Global Insight's report on demand side response, commissioned by the DTI and Ofgem, which found that emergency cash out prices did not have any bearing on the level of demand side response. Psychological factors and environmental constraints were identified as factors which hindered demand side response. Another respondent shared this view and considered that unless customer concerns about participating in demand side response are properly addressed then the implementation of the modification proposal 044, or similar

[19] BSC Modification Proposal P135 ("Marginal System Buy Price During Periods of Demand Reduction") sought to amend the electricity Energy Imbalance Price calculation such that the System Buy Price would be calculated using a marginal methodology during periods of demand control and where the system is short.

measures, may only act as penalties. These respondents considered that the only changes that will encourage demand side participation this winter will be those developed pursuant to the Demand Side Working Group (DSWG) activity, not those relating to the emergency cash out arrangements. One respondent also noted that British manufacturers have warned that they may need to cut production this winter as a result of the high prices and therefore considered that this clearly indicated that the demand side response is working well without the need for this modification proposal.

Another respondent opposed to modification proposal 044 considered that demand side response was critical to the emergency cash out regime debate, noting that commercial demand side options should be fully developed and exhausted before emergency conditions were declared.

GS(M)R monitor breach

One respondent expressed concern regarding the potential implications of the proposed changes in the event of an emergency that is triggered by the breach of the short term storage monitor level. This respondent noted that in the short term the most likely monitor to be breached would be LNG storage and that it could take several days to replenish the storage facility. In this situation, industry would be faced with a lengthy emergency situation and exposure to extreme cash out prices. Another respondent with similar concerns stated that the issue of recovery from an emergency caused by a short term LNG storage breach, was an issue that required further consideration.

Markets and Command & Control

Several respondents requested further clarification on how Over-The-Counter (OTC) trading would respond to suspension of the market. One respondent opposed to the modification proposal stated that it was not clear how increasing the cash out price in a situation where there was limited opportunity to resolve an imbalance position would improve competition between shippers.

One respondent considered that the interactions between markets and command and control had not been properly thought through. Another respondent agreed with this view and considered that, as a result of industry discussions, command and control and market mechanisms could not work together.

One respondent was of the same view as one of the respondents offering qualified support in that the proposed sharper cash out prices would be unlikely to incentivise price sensitive deliveries to the UK but that there was a need to consider wider issues, including contracting arrangements, market liberalisation and European market conditions leading up to and during the emergency.

ECQ

Several of the respondents who did not support the modification proposal considered that there had been insufficient discussion as to how, in practice, the ECQ calculation would work. These respondents considered that in an emergency the administration and processing of the P70 forms would detract from the emergency situation especially one that has developed quickly. The respondent was concerned that these arrangements would add additional complexity to the current arrangements. In this situation it would be unlikely that Transco NTS would have time to process a large number of forms to decide who to interrupt, which could lead to Transco NTS miscalculating the amount of gas available. One of the respondents acknowledged that there would be an appeals process in place but considered that it would be better to get it right from the start rather than going through some complex appeals process that may take months to resolve. Another respondent considered that Transco NTS's refusal to include price claims into the claims process undermined any value it could have. It was also noted by several respondents that in theory each individual gas transporter could adopt its own methodology which would increase the uncertainty and fragmentation ahead of this winter and it would therefore be beneficial for a common methodology to be adopted.

Several respondents accepted the principle behind the ECQ and accepted that the supply and demand situation this winter would be potentially tight. However, these respondents considered that the uncertainty of the ECQ would put an additional strain on the market and could prolong the duration of an emergency. One respondent considered that diverting resources away from the gas emergency due to the P70 forms would not be in the interest of security of supply and therefore would not better facilitate the economic and efficient operation of the system. This respondent also considered that it is not clear whether or not a shipper can view its imbalance position, especially on days when the ECQ has been calculated within day. The respondent was of the view that if a shipper is unable to see its imbalance position, it is unclear that the shipper would be able to take sufficient actions to mitigate its position and help balance the system. One respondent considered that it was unclear whether a shipper can sell its entire interrupted load in an emergency or just the partial amount. This respondent requested that Transco NTS provide further clarification on this point if the modification proposal was implemented.

Another respondent reiterated that the speed at which this modification proposal was "rushed through" had led to the ECQ part of the proposal not being fully developed. This respondent also stated that currently the Interruption Manager (IM) is calculated in volumes, whereas the requirements for the calculation are in energy terms. Another respondent stated that the impact assessment carried out in relation to modification proposal 021 indicated that there would be a system lead-time of two months to implement the necessary systems to cope with the volume element of the proposal. This respondent considered that given the additional complexity of the volume aspect of this proposal, the lead time would probably be greater.

Process

Several of the respondents expressed concerns over the process that has been followed in respect of this modification proposal. These respondents noted that the draft modification report was issued on 10 August 2005, the workstream meeting was on 11 August and since that meeting numerous notes have been circulated attempting to clarify aspects of the modification proposal. Several respondents argued that urgent modification proposals should be reasonably well developed and defined before going out for consultation.

Several of the respondents also considered that an impact assessment on this modification would be necessary to obtain a better understanding of the costs and benefits of this proposal.

Panel's recommendation

Modification proposal 042

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 modification proposal.

Modification proposal 044

At the Modification Panel meeting held on 1 September 2005, of the nine voting members present, capable of casting ten votes, two votes were cast in favour of implementing this modification proposal. Therefore the Panel did not recommend implementation of this modification proposal.

Ofgem's view

Ofgem has carefully considered the views of respondents and the Panel in relation to both modification proposals 042 and 044. As both modification proposals are seeking to address the same concerns, Ofgem has considered whether these modification proposals would better facilitate achievement of the relevant objectives as set out in Standard Special Condition A11 of the relevant gas transporters' licences. Having regard to its principal objectives and wider statutory and public law duties, Ofgem considers that both modification proposal 042 and modification proposal 044 would better facilitate achievement of the relevant code objectives compared to the existing UNC baseline. However, Ofgem also considers that, having regard to the matters set out below and given that the two modification proposals are mutually exclusive, modification proposal 044 would better facilitate achievement of the relevant objectives as compared with modification proposal 042.

Both proposals were raised in response to the concerns which modification proposal 021 sought to address and seek to take account of the issues raised by that proposal. In its decision letter in relation to modification proposal 021 Ofgem sets out in detail:

- its views on the issues that UNC modification proposal 021 was seeking to address; and
- its assessment of the positive aspects of UNC modification proposal 021 and the areas in which Ofgem considered the modification proposal could be improved.

In this light, Ofgem sets out below the reasons for the Authority's decision not to accept modification proposal 042 and to accept modification proposal 044, drawing on its previous assessment of modification proposal 021. Ofgem considers:

- its assessment of the modifications against the relevant objectives and the Authority's Statutory duties; and
- procedural issues associated with modification proposal 042 and modification proposal 044.

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

Price component

For a shipper that is short gas, E.ON UK's proposal (modification proposal 042) would result in the emergency cash out arrangements being modified so that rather than being charged the 30 day average SAP for its shortfall of gas, the shipper would pay the prevailing SAP. In contrast, under Transco NTS's proposal (modification proposal 044) the shipper would have to pay the SMP Buy price for its imbalance.

For shippers who are short gas in the days or hours leading up to an emergency both SAP and SMP Buy are likely to provide stronger incentives than the current 30 day average SAP to procure gas or demand side response from market sources and, therefore, to address their imbalance through the normal market mechanisms. By improving the incentives for shippers to balance their positions in situations where the gas market is close to an emergency, it follows that the likelihood of a stage 2 emergency occurring is reduced, and that any emergency that is called would be expected to be shorter in duration than would have otherwise been the case.

Under modification proposal 042, while the incentive would be stronger than under the current arrangements, it would be weaker when compared to the proposed arrangements in modification proposal 044. Ofgem considers that the market valuation of gas immediately prior to an emergency being called is likely to be higher than an averaged price over a period in the build up towards an emergency being declared. Therefore, unless an emergency was declared at the start of the gas day, any method which sets emergency cash out prices to an average level for the day would be likely to undervalue gas at the start and during an emergency. Ofgem therefore considers that the incentives associated with cash out prices set by SMP Buy would be more appropriate, and would encourage shippers to source gas from price sensitive sources including the interconnector and LNG imports in an efficient manner, reflecting the market value of gas in GB.

At present, the emergency arrangements potentially create a perverse incentive in which a shipper that is short of gas may gain financially if the overall system enters stage 2 of an emergency and is, therefore, discouraged, from a financial perspective, from addressing a short gas imbalance. Ofgem considers that modification proposal 044 better addresses this perverse incentive than modification proposal 042, again because SMP Buy is more likely to reflect the market valuation of gas immediately prior to an emergency being called.

For shippers who are long gas, the price components of modification proposal 042 and modification proposal 044 are similar: the shippers would be paid SAP (as calculated for the day on which the emergency was declared) rather than 30 day average SAP. As stated in the decision letter for modification proposal 021, for shippers who are long and do not trade out their position, since SAP is very likely to be greater than 30 day average SAP in the run up to a gas emergency, this is likely to provide an additional incentive for long shippers to provide more gas onto the system during an emergency relative to the current arrangements. Ofgem therefore considers that paying shippers that are long SAP rather than 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 imports to flow into the GB market.

In addition, Ofgem would expect shippers who are long gas to attempt to contract with shippers who are short gas after an emergency has been declared and throughout its duration. Under modification proposal 044, those shippers would be willing to pay a price up to the SMP Buy price to reduce their imbalance, whereas under modification proposal 042, they would have no additional incentives to pay above the prevailing SAP. Shippers who are long gas and trade out their position in this way would therefore receive a higher price for their gas under modification proposal 044 than under 042.

Ofgem therefore considers that the combination of cash out prices proposed under modification proposal 044 better promotes the economic and efficient operation of the system by providing enhanced incentives for parties to trade out any imbalance.

In relation to modification proposal 021, Ofgem highlighted a number of areas of potential improvement which it stated would need to be introduced in advance of this winter, and were therefore critical to the emergency cash out arrangements.

The first of these issues was the ability to trade out imbalances during an emergency period in the face of cash out incentives. This is clearly central to the potential benefits of the modifications. Transco NTS has made clear, as part of modification proposal 044 that participants would be able to trade out imbalances throughout the emergency period. Ofgem notes that this is not made explicit in modification proposal 042, although, as stated in the decision letter in relation to modification proposal 021, Transco NTS has given Ofgem assurances that the UNC provides for them to accept nominations in relation to OTC trades during Stages 2 and 3 of an emergency and that Transco NTS would in any event operate the system so as to allow such nominations. Ofgem considers that in stage 2 when the OCM is suspended and command and control is instigated, that the continuation of the OTC market would enable long shippers and short shippers to be able to trade with each other and would also allow shippers to contract with sources of price sensitive gas.

The other key area of improvement Ofgem highlighted related to the risk that, if the pre-emergency SMP Buy price was used as a cash out price, the purchase of a relatively small volume of gas by Transco NTS could set cash out prices for a long period of time. Ofgem suggested that a more aggregated form of "marginal" pricing (for example a price based on some combination of the most expensive trades taken on the day) may be more appropriate than pure marginal pricing. A number of respondents raised this issue and were concerned that Transco NTS had not addressed this issue directly in the modification proposal itself. Transco NTS has however stated in the modification proposal that 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 the overall supply/demand balance position.

Ofgem considers that this statement provides comfort in relation to the de minimis issue. On this, Ofgem notes that discussions in the Demand Side Working Group and individual respondents have highlighted that shippers are keen to understand the threshold volume above which Transco NTS believes actions will have a discernible impact. Ofgem considers that Transco NTS should formalise its position in this respect via an amendment to the System Management Principles Statement as soon as possible.

In conclusion, Ofgem considers that the price element of the proposal for both 042 and 044 better facilitates A11(a) of the relevant objectives when compared to the existing baseline, but considers, for the reasons summarised above, that modification proposal 044 better facilitates A11(a) of the relevant objectives when compared to the current baseline and modification proposal 042. However, there are a number of additional areas for potential improvements which Ofgem still considers should be addressed in the medium term.

Ofgem notes the concerns that were raised by respondents as to whether it was appropriate to have a dual price cash out mechanism for all emergencies. In particular, shippers were concerned that a distinction should be made between a progressive gas emergency (caused by, for example, bad weather conditions) and an unexpected emergency. Respondents expressed concern that, in a sudden emergency, shippers may not have time to respond to strong price incentives. Ofgem considers that it is highly unlikely that a GDE will not be progressive given the nature of the gas system as in most circumstances it is likely that a GDE will be a consequence a combination of severe weather conditions and other events such as plant failures. Ofgem also notes that Transco NTS can use linepack and operating margins gas to maintain resilience to the sudden loss of major infrastructure for a number of hours. The probability of a GDE occurring rapidly in a way which gave participants insufficient time to respond to price incentives is therefore very low and, on this basis, Ofgem considers that market participants will be able to respond to a dual price cash out mechanism. However, it remains the case that market participants are free to consider the treatment of sudden gas emergencies within the existing governance structures.

Volume component

In stage one of a GDE, Transco NTS has the right to interrupt any site that has elected to have interruptible transportation arrangements. At stage 3, Transco NTS may curtail offtake by firm end-users. Under the current arrangements, following Transco NTS curtailment (of either firm or interruptible load), a shipper's short gas position would be improved by the volume of the curtailment. Therefore, if a shipper thought it was reasonably likely that curtailment would be instigated, it might prefer to wait for Transco NTS to curtail its customer once an emergency has been declared and have its imbalance position improved by Transco NTS, without having to enter into commercial demand side contracts with its customers or going to the market to procure more gas to resolve its imbalance.

The volume component of modification proposal 044 has the effect of leaving shippers' imbalance positions neutral to the effects of curtailment of their customers by Transco NTS. By associating a title trade with an emergency curtailment, shippers' imbalance positions are kept constant irrespective of any curtailment by Transco NTS. The effect of this should be to provide stronger commercial incentives on shippers to contract for commercial interruption both prior to and in an emergency (and also to take supply side steps to resolve their imbalance position), rather than waiting for Transco NTS to curtail significant loads.

In Ofgem's decision letter in relation to modification proposal 021, it noted two key areas which Ofgem considered would be critical complements to the volume component of the arrangements proposed in that modification. These have both been addressed in modification proposal 044:

- **The different treatment of firm and interruptible customers**: in modification proposal 044, Transco NTS has proposed to remove the arbitrary distinction between firm and interruptible customers which was proposed in modification proposal 021. The revised distinction between the treatment of firm and interruptible customers should ensure that the incentives which shippers face regarding *ex ante* contracting for demand response are stronger than under the current arrangements for both customer types; and
- **The lack of explicit treatment of disputes in relation to the calculation of the volume component**: in modification proposal 044, Transco NTS has included details as to how disputes in relation to the calculation of the volume of load curtailed (and hence the volume of the title trade) would be addressed, to provide clarity for shippers.

Modification proposal 042 does not amend the existing treatment of curtailment volumes and retains the status quo in this respect. For the reasons set out above, Ofgem therefore considers that the volume element of modification proposal 044 in principle better facilitates relevant objective (a) as opposed to the current baseline and modification proposal 042. However, there are a number of additional areas for potential improvements which Ofgem still considers should be addressed in the medium term.

Ofgem notes the concerns of several respondents with respect to the ECQ methodology specifically that under modification proposal 044 the methodology for calculating the ECQ volume would not be set out in the UNC. While Transco NTS has proposed a methodology for calculating the ECQ volume, it has indicated that other transporters would be free to develop their own methodology. This could lead to a number of different methodologies co-existing, and hence could result in shipper uncertainty as to the treatment of particular loads (and potentially differential treatment of loads connected to different networks). Ofgem also notes that respondents have raised a number of issues in relation to details of the methodology proposed by Transco NTS, most particularly in relation to the method of submission of P70 and P70 firm forms. Respondents indicated a view that a requirement to submit these forms by fax during a gas emergency may not be appropriate, and that electronic submission mechanisms may be preferable.

In respect of these issues Ofgem sees merit in the inclusion of a single methodology for all relevant transporters within the UNC in the medium term and the enhancement of the operation of this methodology (e.g. the operation of the P70 process) to be further developed as part of this process. However, until such time as these steps are taken, Ofgem considers that it will be important for:

- Transco NTS and the other relevant transporters to engage in discussions as to the development of a harmonised methodology which is acceptable to all parties, and the operation of which is fit for purpose. This work could be taken forward by the Gas Transporters Forum;
- Relevant gas transporters to formalise their methodologies for calculating ECQ volume; and
- Relevant gas transporters and shippers should work together to address any operational issues, such as the P70 process, associated with putting the methodology into practice.

Ofgem's view against relevant objective (a)

Given the nature of the concerns in relation to the current emergency cash out arrangements, Ofgem considers that both modification proposals would better facilitate relevant objective (a) *against the current baseline*. However, for the reasons set out above, Ofgem considers that, relative to modification proposal 042, modification proposal 044 would better facilitate relevant objective (a).

Standard Special Condition A 11 (b) – so far as is consistent with (a), the co-ordinated, efficient and economical operation of (i) the combined pipeline system and/or (ii) the pipe line system of one or more other relevant gas transporters

Ofgem notes the concerns of the DNs with respect to the additional complexity the volume aspect of modification proposal 044 could add to the current arrangements[20]. However, given its conclusions against relevant objective (a), Ofgem considers that modification proposal 044 is also likely to better facilitate the co-ordinated, efficient and economical operation of the pipeline system. Ofgem considers that ongoing work of the nature flagged above in relation to the development of a common ECQ methodology across all relevant transporters and the enhanced operation of it should enable these concerns to be addressed in an appropriate manner. Therefore, Ofgem considers that it is important for work on this matter to be progressed in a timely manner in order to address these areas. At this stage, therefore, Ofgem does not consider that these concerns are sufficient to mean that modification proposal 044 does not better facilitate the achievement of relevant objective (b).

[20] Ofgem notes that similar concerns were not raised in relation to modification proposal 042 given that it has no volume component.

Ofgem's view against relevant objective (b)

Overall, and in light of its conclusions against relevant objective (a), Ofgem considers that modification proposals 042 and 044 are also likely to better facilitate the co-ordinated, efficient and economical operation of the pipeline system relative to the existing baseline and that modification proposal 044 is better in this respect than modification proposal 042.

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

Price component

It is crucial that costs are appropriately targeted to prevent distortion of competition between the relevant shippers and suppliers. In relation to the cash out arrangements, it is clearly important that those shippers whose portfolios are balanced are not exposed to the costs of Transco NTS undertaking balancing actions for those shippers that are not in balance.

At present, the emergency cash out arrangements represent a form of "collective insurance". Shippers that are short gas pay a price for the shortfall which is lower than the true market value of the gas, and conversely, shippers that have surplus gas receive a price below the true market value. The arrangements therefore act to insure the shippers that are short gas at a cost to the shippers who are long gas.

As Ofgem noted in its decision letter in relation to modification proposal 021, the collective insurance model provides perverse incentives for those shippers that are short gas. The lack of cost targeting 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 a cross subsidy between shippers.

While both modification proposal 042 and modification proposal 044 would *reduce* the extent of collective insurance by revising the cash out prices as discussed above, Ofgem considers that, by introducing dual cash out arrangements under which cash out prices better reflect the market value of gas on the GB system immediately prior to an emergency, modification proposal 044 would *remove* any element of collective insurance and would ensure that costs are appropriately targeted to prevent distortion of competition between relevant shippers and suppliers. Ofgem considers that modification proposal 044 would therefore promote competition.

Volume component

By providing shippers and customers with commercial incentives to make *ex ante* contractual arrangements for use before and during an emergency, including contracting for demand side response, Ofgem considers that modification proposal 044 is likely to facilitate effective competition between shippers. This is because it should ensure that there are more competing sources of gas and demand side response in the market in the run up to an emergency, which would, therefore, help to avoid the emergency and maintain the full competitive gas market arrangements in force.

Modification proposal 042 does not amend the proposals for the treatment of curtailment volumes, and therefore Ofgem considers that it does not improve incentives for *ex ante* contracting of demand side response.

Ofgem notes the concerns raised by a couple of respondents that emergency cash out prices would have no effect on the level of demand side response. However, Ofgem considers that both the volume and the price element of this modification together would create additional incentives on shippers and the demand side to offer the necessary demand side response in the run up to an emergency. In relation to the comments raised concerning the DSWG, Ofgem considers that this group is attempting to ensure that firm customers are able to offer demand side response for a number of days. Ofgem is of the view that this modification proposal and the progress being made by the DSWG will provide additional incentives on the demand side to respond on days when the system is tight and enhance its ability to do so.

Ofgem's view against relevant objective (d)

Ofgem considers that both modification proposals would better facilitate relevant objective (d) *against the current baseline*. However, for the reasons set out above, Ofgem considers that, relative to modification proposal 042, modification proposal 044 would better facilitate relevant objective (d). Nevertheless, Ofgem considers that there are aspects of both proposals which, from the viewpoint of facilitating competition, merit further consideration.

Ofgem notes that respondents raised concerns regarding the potential information asymmetries in the run up to a gas emergency, and the implications of those information asymmetries for shippers who do not have upstream interests if the incentives to balance in an emergency are heightened. Ofgem considers that, in combination with cash out arrangements which ensure that shippers who are out of balance in an emergency face a cash out liability which reflects more closely the true value of gas, the existence of information asymmetries in relation to the likelihood and timing of any trigger of an emergency could distort competition by giving certain shippers an unfair competitive advantage (for example, they would be able to attempt to source additional gas at an earlier stage, before the emergency became public knowledge and therefore, perhaps before prices have fully adjusted). Ofgem therefore considers that this is an area which would benefit from further development.

Standard Special Condition A 11 (e) - so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure domestic customer supply security standards (within the meaning of paragraph 4 of standard condition 32A (Security of Supply – Domestic Customers) of the standard conditions of Gas Suppliers' licences) are satisfied as respects the availability of gas to their domestic customers

Ofgem notes that E.ON UK considers that the implementation of modification proposal 042 would generate reasonable economic incentives to promote compliance with the domestic customer supply security standards and hence will better facilitate relevant objective (e).

NG, in its preliminary Winter Outlook Report, has stated that supply to domestic customers would be secure even in extreme winter conditions. Equally, the proposal does not contain any provisions which relate specifically to incentives in relation to domestic customer security standards. Therefore Ofgem does not consider that either of the modification proposals better facilitates relevant objective (e) in particular.

However, insofar as Ofgem considers that there are elements of the modification proposals which better facilitate relevant objectives (a) and (d), and which would reduce the chance of the occurrence of a gas emergency and the potential duration of any emergency, then those elements should facilitate improved security of supply for all customers, including domestic load.

Ofgem's view against relevant objective (e)

Therefore, Ofgem considers that insofar as the modification proposals better facilitate relevant objectives (a) and (d), then the modification proposals should facilitate improved security of supply for all customers, including domestic load. As discussed above, Ofgem considers that modification proposal 044 better facilitates both relevant objectives (a) and (d) compared with modification proposal 042. Therefore, Ofgem considers that modification proposal 044 better facilitates relevant objective (e) relative to modification proposal 042.

Wider statutory duties

Protecting customers

Overall, Ofgem considers that both modification proposals 042 and 044 would protect the interests of customers through enhancing the economic and efficient operation of the system as well as promoting competition in the wholesale and retail markets. Ofgem notes that customer groups expressed support for the price element of modification proposal 042 and for both the price and volume components of modification proposal 044.

Security of supply

As noted above, Ofgem considers that both modification proposals 042 and 044 reduce the likelihood of an emergency situation arising relative to the current arrangements and provide incentives for the delivery of gas throughout the duration of an emergency, which should help to minimise its duration.

Given that an emergency situation would lead to the enforced curtailment of some customers' gas, any enhancements to the arrangements that increases the probability of avoiding an emergency situation can be considered to better facilitate security of supply.

As argued above, Ofgem considers that modification proposal 044 provides more appropriate economic incentives in the run up to and during a gas emergency. Therefore Ofgem considers that this modification is more likely to facilitate security of supply than modification proposal 042.

Procedural issues

A number of respondents expressed continued concerns in relation to the treatment of the modifications as urgent, and the resulting short timeframes for debate and consultation in the industry.

Ofgem has on a number of occasions made it clear that it considers that the issues that these proposals attempt to address are very important, particularly for this coming winter and these issues have been widely discussed, as set out above. As it stated in its decision letter in relation to the request for urgency, Ofgem considers the justification for urgency accords with its guidelines for granting urgency status to a modification proposal[21]. In particular, Ofgem considers that if the modification proposals were to have followed non-urgent procedures, there would have been a risk that, were one of the modification proposals to be subsequently implemented, there would be insufficient time for the market to properly consider the likely impact of that modification and react accordingly, prior to this coming winter. Ofgem also

[21] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2752_Urgency_Criteria.pdf

considers that had the modification proposals not been treated as urgent, this could have had an impact on security of supply for the winter ahead.

Ofgem considers that, in this context, whilst ideally more time would have been allowed for consideration of these proposals, the consultation process has been adequate and that the proposers have taken reasonable steps to ensure that the details and effects of the proposals have been articulated so as to allow industry participants properly to respond to them.

Ofgem has not conducted impact assessments in relation to modification proposals 042 and 044 because it has been impracticable to do so given the urgent status and expedited timetable associated with the modification proposals. This is in accordance with section 5A (1) of the Utilities Act 2000.

Wider issues

As with modification proposal 021, both modification proposal 042 and modification proposal 044 raise a number of further issues in relation to the gas emergency arrangements more generally which would benefit from further consideration by interested parties. Issues in addition to those raised in relation to modification proposal 021 are discussed below.

GS(M)R monitor breach

Ofgem has noted respondents' views on this issue and considers that it may be appropriate for market participants to review the implications of a GS(M)R monitor breach in terms of the initiation of emergency arrangements. However, in the context of the comments raised by respondents, a GS(M)R monitor breach is only likely to trigger entry into stage 1 of an emergency, with stage 2 only likely to be reached if the situation evolves into a gas deficit emergency.

Electricity market emergency cash out arrangements

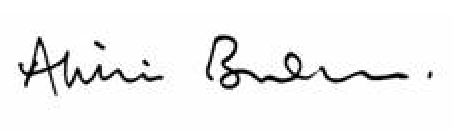
Given the extent of interaction between the gas and electricity markets, the revision of the gas emergency cash out arrangements may mean that it is appropriate to review the operation and impact of the emergency arrangements for the electricity market, in order to assess whether they continue to be appropriate.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject modification proposal 042 and to accept modification proposal 044.

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

Yours sincerely



Alistair Buchanan
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