Shell Gas Direct Limited

Uniform Modification Proposal 0044
Revised Emergency Cash-out & Curtailment Arrangements

I refer to the above urgent modification proposal raised Transco NTS. It proposals major and significant changes to the emergency cash-out arrangements (ECOA) for winter 2005/06. These changes include moving to a dual priced emergency cash out price, introducing emergency curtailment quantities for all system exit points (interruptible and firm); introduction of a disputes resolution process etc.

Shell Gas Direct (SGD) does not support the implementation of this proposal. We set out below our reasoning for this. However, we consider that the proposal raises many issues which cannot be fully addressed given the short time scales for discussion on this proposal. In setting out our view, we have considered not only the modification proposal but also Ofgem's decision letter on Transco NTS's previous proposal, UNC 0021 (hereafter "OD0021").

As we stated in our response to UNC0021, Shell takes its commitments to ensuring security of the UK gas system very seriously. Like Ofgem and NGT, we are certainly aware of external pressure to ensure that the safety of the system is ensured for this winter and we intend to play our part

Process

Ofgem's decision letter sets out some of the concerns that the Authority expressed about the consultation process. SGD considers that there continue to be serious issues with the processes that both Ofgem and Transco NTS have adopted which has resulted in urgent proposals being raised in the run up to what they both consider to be a tight winter.

As we stated in our response to 0021, we do note that Ofgem and National Grid agreed with each other regarding the need for ECOA to be looked at in the winter operations report. This proposal and UNC0021 do not reflect discussions at the CORWG. This raises issues about the winter operations report processes, how transparent it is, and whether assessments should be carried out by National Grid or by an independent third party. The process needs to ensure that shippers are included in all discussions defining issues that arise and their solutions: this is not in place at present.

The approach adopted to considering ECOA does not appear to demonstrate Ofgem's commitment to the principles of best regulatory practice. Ofgem states in that the issues Transco NTS was attempting to address in UNC 0021 are *"very important, particularly for the coming winter*". While we do not agree with this view, we find it surprising that Ofgem was not able to send anyone working on these issues from the markets division to the Transmission Workstream meeting on 4 August 2005 to explain its 25 page decision document and the principles it would be using in judging future proposals. These principles differ from those previously discussed with the industry and pay no heed to principles that the industry itself has established. That the

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Authority now considers that this issue is "very important" also raises about the work it was prioritising for itself and, by indication, for the industry earlier in the year.

Earlier discussions on CORWG
We note that the Authority considers it regrettable that proposals were not raised earlier to address Ofgem's concerns. We consider it regrettable that Ofgem has not been clear in setting out its concerns nor has it answered queries raised about the *various* approaches to emergency cash-out it has suggested over the years. We would welcome confirmation that the Authority has been fully informed of the extent of legitimate issues raised by industry participants in response to Ofgem's suggestions over the years. Otherwise, it may be perceived that Ofgem has fettered the Authority's discretion by not providing a complete picture.

A review of OD0021 does raise concerns that this has not occurred. In response to Ofgem consultation on cash out in 2004, no gas industry participant considered that there were issues requiring a review. It is the case that Ofgem set out a view that emergency cash out needed to be looked at the CORWG, but Ofgem's view was based on a letter it had previously circulated to the industry which had already been discussed in detail. That letter had revealed misperceptions regarding the way emergency cash out worked, the roles of responsibilities of shippers[1] and gas transporters (eg on who actually phoned up the firm sites to disconnect them etc). The concern must be not that the lack of industry response but rather raises issues regarding Ofgem's knowledge management and ability to respond to legitimate issues raised by the industry. Shell wrote to the Managing Director of Markets in July 2003 outlining our concerns with proposal 0536 and asking for clarification on a number of points raised by Ofgem staff at meetings discussing ECOA. We note that we did not receive a response to this letter.

Ofgem's previous discussions on ECOA have not exactly been along the lines of this proposal. Rather, Ofgem has been focussed on getting market mechanisms to solve problems which could be created by market failures. A principles established in industry discussions was that the market and command-and-control can not work together. Ofgem has not accepted this and has been asked on a number of occasions to provide analysis or examples of markets and command-and-control working together but have not been able to do this. The Authority should not be making a decision based on the assumption that there has been a reluctance by shippers to address genuine security of supply problems but rather that Ofgem has omitted to address issues and provide clarity of its views.

It is not that case that Ofgem has consistently called for certain types of reform to ECOA. It should note that Ofgem's priorities earlier in 2005 did not appear to put this at top of agenda. Furthermore, we note for example Ofgem's statements in its letter on M0568, ***"****we are not convinced by the case for increasing the price for cashing out imbalances. We note the conclusion as part of the GIEC discussions that the level of this price would not encourage more gas onto the system once a supply emergency had commenced. Rather, it would be the "command and control" aspects of the NEC that would ensure sufficient gas came onto the system" Transco and NGC have not identified cash-out prices in an emergency as being an issue that will impact on the safe operation of the gas system* [in winter 2002/03 report]. This does not support the

[1] The term "shipper" in this response also encompasses activities undertaken by suppliers, eg direct contracting with consumers.

impression that is given in OD0021 that Ofgem has consistently asked for proposals to be put forward.

Transparency of Ofgem's process
We would welcome more comprehensive responses to these issues when Ofgem makes its decision on this proposal. In the interests of transparency, we request that Ofgem publishes:

- A list of the number and dates of meetings between Transco NTS and Ofgem since the beginning of 2005 where cash-out was discussed. This should include meetings before publication of the winter outlook report, and before and after Transco NTS raised proposal 0021. Note that we are not requesting details of the discussion and see no reason why Ofgem should not consider this a reasonable request.
- Confirmation that the Authority's discretion has not been fettered by material previously presented, ie in relation to the winter operations report, in respect to emergency cash out arrangements. The Authority should demonstrate that it has a complete overview of the discussions on ECOA over the past five years if accepting this proposal.
- We see no reference in OD0021 to the Memorandum of Understanding signed by industry chief executives in 2001 and launched by the Minister of Energy. We assume that the Authority is fully aware of this. In our view, Ofgem underestimates the costs to individual market participants and the industry collectively of reputational damage.

Cash out review working group (CORWG)

It should be noted that this group was established after a consultation by Ofgem where no respondents in the gas industry raised issues with the current cash out arrangements. Furthermore, this group replicated discussions which have and can continue to take place in industry workstream.

In the modification report for UNC0044, Transco NTS makes a number of assertions regarding the discussions which took place. From minutes of the meetings and discussions with attendees, it is clear that these are the views of Transco NTS only and do not reflect any agreement. CORWG did not recognise *"that the creation of the Safety Monitors and the potential for a breach of those Safety Monitors had made the potential of a GDE more predictable"*. This is not the case and Ofgem's decisions letter on M710 which introduced Safety Monitors states that *"We consider that the arrangements in gas will be sufficient to allow customers to interrupt, if they choose to do so, in response to the price signals.."*

A barrier to greater demand-side participation *by customers* (ie not as a result of what Transco NTS perceives to be shippers' incentives) is that there is insufficient information available to customers to make these predictable[2]. This issue has formed part of the discussions at Demand Side Working Group (DSWG) which we discuss in further detail below. It is also not that case that there was an agreed recognition *"that appropriate incentives were required to encourage Users to take appropriate action"*.

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[2] In our response to UNC0021, we raised issues regarding Transco NTS's perceptions of shipper incentives. We do not consider that these have been addressed. We do not consider that Ofgem should necessarily consider that Transco NTS's views on shipper incentives as being objective.

Shippers are generally of the view that those incentives are already in place. As set out in our response to 0021, only Transco NTS *"noted that the current arrangements might not appropriately incentivise Users to take all action that could be considered prudent*" although we note that Ofgem appears to have agreed with Transco NTS's view.

Transco NTS also suggests *"that one of the principle outcomes of CORWG discussion was the recognition that appropriate incentives were required to encourage shippers to take appropriate actions."* We are not aware of any consensus on this point being agreed and assume that this is the view of Transco NTS and/or Ofgem. Shippers consider that appropriate incentives *are in place* to ensure that shippers take appropriate actions.

Impact of proposal on demand-side response

The proposer states that *"revised emergency arrangement should lead to greater incentives on Users to contract for and action commercial "interruption"".* Ofgem is of similar view equating the requirement for "financial incentives" with *"companies genuinely [doing] all that they could do, for example, by, secur [ing] demand side response."*

There are two questions which arise in light of these statements: 1) Do these statements reflect the market arrangements that are currently in place; and, 2) Will this proposal increase the potential for demand side response? In our view, the answer to both of these is "no".

Market arrangements & Security of Supply requirements

The market arrangements which have developed since the introduction of the network code in 1996 are based on a liquid traded market at the NBP and shippers' incentives to balance inputs and offtakes. Shippers are not uniformally of the same set up nor do they uniformally take the same approach. This should be seen as a strength of the market arrangements, not a weakness. A shipper with customers ("Shipper A") can cover their positions in the market by buying physical gas (ie from a producer) or title to gas (ie from the traded market). Shipper A may purchase gas in the market from traders ("Shipper B") who in turn may have arrangements with storage operators, to import gas through the Internconnector, etc. Or a trader could decide to go short as it takes a risk on the direction of the market – as a purchaser, should Shipper A be demanding evidence of physical deliveries from Shipper A. Furthermore, if events make Shipper B short of gas at very short notice (as can occur in an emergency), how will Shipper B access demand side from Shipper A.? (Further discussion on identified barriers to demand side is set out below?). Similarly if the purchase is from a storage operator (Shipper C) and Shipper C cannot deliver, Shipper A is still in balance but Shipper C has no customers to directly approach for demand side. The approach taken with this proposal appears to suggest that this market-based activity should not be undertaken and instead shippers should cover their gas demand with physical deliveries. Already there are concerns about liquidity in the future market[3]: this proposal will undermine it further which will not be in the interests of consumers.

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[3] See for example, Global Insight's Report to the DTI, "Ensuring Effective and Efficient Forward Gas Markets", March 2005

The proposal could expose shippers to considerable cost and risk if the winter is colder than that set out in the domestic supply security standards in the suppliers' standard licence conditions. These standards are defined by reference to winters which are exceeded only 1 year out of 20 years. This proposal is a marked departure from this and we would expect if this standard is exceeded that the requirements would be suspended. Otherwise, Ofgem should have taken this forward through amendment to licence conditions here as well as making standard requirements for shipper interruption in the licence.

Demand side and DSWG

We note that UNC0021 was raised days after the publication by Global Insight's Report for the DTI and Ofgem on demand side response[4] and yet neither that proposal nor this one takes any account of the findings of that report. The report did not find that emergency cash out prices had any bearing on the level of demand side response. What it did find was that there were groups of customers with strong incentives to participat in demand side activities; that during times of high prices, and that shippers would contact customers to negotiate demand side reduction. Factors which hindered demand side participation included "psychological factors" and environmental constraints. These latter issues are now being addressed through the Demand Side Working Group (DSWG). In both this report and the Winter Operations report, it is noted that there was increased demand side from industrial consumers last year and that there is further potential. There remains no evidence that shippers are not sufficiently incentivised to contract for demand side; there is some evidence that there are barriers relating to customers' understandings and requirements.

In Ofgem's decision on M705, "Changing the basis for supply / demand interruption", it states that "*the current arrangements do not restrict Transco accessing demand side response via shippers through OCM or bilateral contracts.[..] Transco has the flexibility to enter into bilateral contracts, possibly at very short notice*". We remain disappointed that Transco NTS has chosen not to investigate whether this is possible nor has it taken steps to understand better the barriers to more demand side response that exist.

We welcome Ofgem's initiative to extend the Demand Side Working Group (DSWG) to cover gas issues. While we consider it unfortunate that the first meeting of this group focussing on gas did not take place until this summer, good progress is being made at identifying the issues which restrict demand side participation by consumers. Much of this appears to be related to having timely and accessible information available. It is not the case that new information needs to be released but that what is there needs to be made more user-friendly and centralised. Useful discussions have focused on having a gas equivalent of the Notice of Insufficient Margin as there is in electricity. This initiative could result in increasing the confidence of customers so that they will understand and actively seek demand side deals. It is unfortunate that Transco NTS has focussed so much of its resource on coming up with complex emergency cash out proposals while not proactively pursuing the proposals raised through DSWG and its subgroups. Ofgem has stressed the importance of this work in these meetings which is welcome. If any changes are implemented to encourage demand side participation for the winter it will be through this activity, not as a result of changes to ECOA. DSWG initiatives can also ensure that gas is released to the market when things are tight through a shipper (as Shipper A above) which can be traded to help out those without

[4] Global Insight, Report for DTI and Ofgem, "Estimation of Industrial Buyers' Potential Demand Response to Short Periods of High Gas and Electricity Prices", 20 May 2005

customer portfolios (eg Shippers B and C), ensuring the sytem is in balance and avoiding emergencies.

Finally, we note recent press reports that "British manufacturers haver warned that they may have to half production this winter as a result [of higher gas prices"[5]. This would indicate that demand side response is working well in reaction to market prices, as Ofgem had previously suggested it would.

Shipper costs & priorities

Shippers' focus in relation to security of supply is on ensuring robust emergency contact details[6] and robust emergency interruptions procedures. These arrangements will be tested shortly and the results will be closely studied by the HSE. It is unfortunate that this work is being sidetracked by the need for discussions on ECOA and potential implementation implications for shippers. To the extent that this diverts resources, security of supply will be undermined.

This proposal involves a major change to shippers' risks and requirements. It also will change arrangements with customers. We cannot see how it can be implemented without an impact assessment. Costs which should include:

- Costs to shippers and to customers of renegotiating contracts at short notice;
- Regulatory uncertainty;
- Costs to shippers to ensure emergency interruption; potential of failure to interrupt charges; potential fines under Gas Safety (Management) Regulations
- Reputational risk: if it is identified that one shipper is responsible, there is likely to be a significant cost.
- Reputational risk if there is a problem overall: this should include the costs of investigations, inquiries etc
- Costs of all or part of the network going down on long term contracts; implications for Force Majeur clauses; costs of customer enquiries, relight programmes etc.

There are a considerable number of reasons why all shippers would wish to avoid any phase of emergency procedures, which the above only partly covers. These should be set out and costed in an impact assessment.

Details of proposal

Dual price cash out

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[5] From "UK's TISC chairman willing to launch another gas price probe". 18 August 2005

[6] We emphasise that although the suppliers currently collect these, they have no direct use for this information as the gas transporters make the contact to interrupt firm sites in an emergency; ie ECOA have no impact on the already considerable incentives on shippers to collect this data. (Although, there is the potential for the shipper to be directed to make this contact.)

We note that in a recent paper by Professor Stephen Littlechild[7], he sets out problems with a dual cash-out price regime and notes, in particular, that it introduces a bias against smaller suppliers. While the issues he raises may not apply directly to ECOA, it not clear to us that it introduces better cost targeting and is likely to result in a tax on certain types of participants. As such, it can be seen as introducing discriminatory arrangements.

Disputes resolution

A principle established when the industry first considered ECOA was that any arrangements should "reduce the number and size of claims for financial loss, and hence for hence the time and effort taken to resolve matters after an emergency." [8] We do not know when or how it was decided that this principle no longer applied. If an emergency does occur and a lot of time and effort taken to resolve matters, it will increase costs for all parties. While a disputes resolution process mitigates somewhat concerns that have been raised, it is insufficient. We consider Transco NTS's refusal to include price claims in this process undermines any value that this could have.

We would welcome National Grid's confirmation that if the dispute resolution process is used and any costs to Transco NTS arise, it will pay for these direct and not be seeking to recover any monies through an Income Adjustment Event. Otherwise, it appears that Transco NTS would be able to avoid financial risk while continuing to increase risk to the industry.

Conclusion

Shell Gas Direct does not support this modification proposal. By introducing costs and risks on shippers and large customers, consumers' interests are not promoted. Implementing this change will introduce resource constraints for shippers and customers, potentially negatively affecting the practical work now being undertaken in the industry to ensure a safe system for winter 2005/06. This will undermine security of supply; not enhance it and contradicts Transco NTS's obligations to operate an efficient and safe pipe-line system. It must be noted that changes to how charges are allocated make no difference to the availability of sites which can be interrupted and these proposals do not reduce the likelihood of an emergency. The proposal will undermine the efficient working of the traded market and therefore undermines effective competition between shippers and relevant suppliers. As such it does not further the Relevant Objectives of the Uniform Network Code.

This proposal raises concerns about the processes adopted by Transco NTS in raising it and the extent to which Ofgem's approach has been in line with its duty to have regard to best regulatory practice, notably in relation to transparency and accountability.

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[7] Stephen Littlechild, "Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations" 19 June 2005

[8] See for example, NWC0052 and minutes, terms of reference etc for the Gas Industry Emergency Committee Commercial implications workgroup which met in 2000/01; and letter from Brian Whithington of Transco to Stephen Smith, Director Trading Arrangements, 3 September 2001.

We recommend that this proposal is rejected. If Ofgem considers that there is merit in some or all of the proposals, we recommend that it publishes a document responding to issues raised now and previously. As we have set out above, we cannot see how this proposal enhances security of supply and believe that it may undermine efforts to ensure robust arrangements for this winter. As the proposal would result in significant changes to the arrangements, we consider it necessary for Ofgem to carry out an impact assessment if it is minded to accept. Consultation with the industry should also set out why Ofgem has not considered amendments to shipper and/or suppliers licence conditions to resolve the issues it perceives. We cannot see how shippers will have the time to re-negotiate contracts before this winter, if this is the intention of the proposal. We do hope that some changes can be implemented in reaction to DSWG activities as this will be in response to better information in the market and common understandings between shippers, customers and Transco NTS.

Shell is aware of concerns regarding security of supply this winter. It remains the case that the industry may get through the winter without any major issues arising and/or cold snaps being dealt with well. However, if demand side response is required and works well, this will be mean that security of supply has been ensured despite, not because of, this proposal. We recommend that further focus on proposals arising from the Demand Side Working Group are more likely to benefit security of supply for this winter.

Yours sincerely

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