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**Response to UNC Modification Proposal 0052 “Storage Withdrawal
Curtailment Arrangements in an Emergency”**

Dear John

E.ON UK supports this proposal because it removes perverse financial incentives within the current gas regime which would otherwise encourage shippers to rapidly deplete stocks of gas in store in the lead up to a possible Network Gas Supply Emergency (NGSE). This may bring forward such a gas emergency or worse still induce an emergency that might otherwise be avoided.

Concerns that the existing tight supply situation coinciding with a colder than average winter might lead to a NGSE, have focused industry efforts on measures designed to minimise the chances of such outcome. Unfortunately the short-time available to develop suitable mitigating measures has meant that any proposals and initiatives pursued by industry participants have necessarily happened in a rather piecemeal fashion.

The perceived benefits of stimulating a shipper demand side response and encouraging the delivery of price sensitive gas were fundamental to Ofgem’s decision to approve Modification 0044. In developing the ‘beneficial’ aspects of this proposal many shippers’ considered Transco NTS failed to appreciate the commercial risks and motivations of shippers or indeed the impact of existing market rules (e.g. in relation to Safety Monitors) on these altered risks/motivations. Ofgem nevertheless recognised key weakness associated with Modification 0044 in its decision letter.

In particular the move from a ‘no fault’, neutral single emergency cash-out price to arguably a more market driven, cost targeted approach under Modification 0044 highlighted the absurdity of the Network Emergency Coordinator having a right to exercise a ‘free option’ to stop shipper’s withdrawing gas from store. Shippers that acquired storage capacity and injected gas into store last summer for the forthcoming winter (2005/06) could not have reasonably anticipated that they might be exposed to a SMP_{buy} price (say conservatively £5/therm) as opposed to the 30

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day SAP price of say 50p/therm, because the NEC might choose to exercise its 'free option'¹ in an emergency under the new post Modification 0044 regime.

Modification proposal 0052 simply seeks to redress the financial impact on shippers that are a result of the above mentioned NEC actions. In so doing this proposal removes the perverse incentive on shippers to withdraw gas from storage earlier than might otherwise have been the case in the lead up to a possible NGSE. Under the current rules (set out in the NEC Safety Case) this perverse incentive may precipitate a NGSE by causing a breach or (or indeed an anticipated breach of) Safety Monitors. Therefore, removal of this perverse incentive better facilitates the *"efficient and economic operation of the pipe-line system to which this relates."*

We believe the 30 day SAP price is likely to represent a fair value for any (Storage Withdrawal Curtailment Quantity Trade) taking into account the value of gas still held in store by the shipper. The price may well be not too dissimilar to the cost of gas injected in store in the summer plus the storage usage costs and the cost that otherwise might have been incurred to replenish the stock of gas the following summer. In the context of seeking to keep shippers 'neutral' to the huge anticipated change in cash-out price from 30 Day SAP to SMP_{buy}, any slight disagreements as to the fair value are somewhat academic. It is also important to note that price for the ECQ Trade was similarly imprecise, but nevertheless set at the 'right' level to ensure the appropriate commercial incentives were placed on shippers to avoid an emergency. Even if the 30 Day SAP price were considered to be too low a price this could be easily view as just rewards for shippers who prudently do not seek to run their stocks down ahead of a possible emergency. Equally the 30 day SAP paid to shippers for the ECQ volume may seem a poor deal for shippers but under the Modification 0044 it was argued by Transco NTS to be the 'right' price with the 'right' incentive properties.

Like Modification 0044 this proposal focuses on behaviours leading up to an emergency with the aim of incentivising 'appropriate' shipper behaviours to help avoid an emergency happening in the first place. It has been suggested that the financial adjustment (i.e. the Storage Withdrawal Curtailment Quantity Trade) described in this proposal may make shippers less inclined to physically take actions to increase deliveries/reduce demands on the system during an actual emergency. This is clearly absurd as shippers will be handsomely rewarded for going 'long' (i.e. will be paid the prevailing SAP at the time the emergency was called which conservatively might be say £3/therm). Not only that if costs exceed this value claims for such additional costs can be lodged.

This proposal also *enhances competition* as prudent shippers who are seeking to conserve stocks for later in the winter will not be unduly discriminated against simply because less prudent shippers have chosen to withdraw gas from store at faster rates.

The removal of top-up was based on an assumption that the **market would deliver** adequate peak flexibility cover to meet demands throughout a cold winter rather than Transco NTS. In supporting the removal of top-up shippers never envisaged that it would be replaced by a 'free-option' introduced via the NEC Safety case developed by Transco NTS. Under the pure market approach rather than the NEC interventionist approach shippers would preserve sufficient stocks of gas throughout the winter because it would make financial sense to withdraw gas

¹ NEC rights to prevent shippers withdrawing gas from storage in an emergency are currently set out in the NEC Safety Case. The Safety Case has been agreed between the Health and safety Executive and Transco NTS without consultation with shippers. Thus Transco has established a free option that has profound implications for shippers and storage operators outside the normal commercial contractual arrangements between Transco NTS and shippers (i.e. the UNC)

when it was most likely to be worth most (i.e. this is likely to be later in the winter period).

Free options, crudely exercised by a conservative minded, risk adverse monopoly system operator can be expected to distort the workings of the market, and inappropriately shifts more risks (some of which are very difficult to manage) on market participants. E.ON UK therefore believes that rather than continuing to look for solutions from the competitive part of the market, greater focus should be placed on the system operator's role (or rather inappropriate role) in that market. We wish to see an end to 'free options' for Transco NTS in its role as residual system balancer.

Nevertheless we recognise it is likely to be difficult for Transco NTS to revisit the whole Storage Monitor concept this year. Modification proposal 0052 is therefore a pragmatic acknowledgement that the flawed Storage Monitor concept is probably here to stay, for the time being at least. It is also recognised that it is unlikely that Transco NTS will volunteer to pursue its abolition with the HSE.

The NEC 'free option' to curtail storage withdrawals *unduly discriminates* against this form of peak flexibility compared to substitute forms of peak flexibility such as beach 'swing' or demand reduction. If this right were to persist without appropriate shipper compensation the prospect of further investment in storage capacity could be damaged which may in turn threaten longer term security of supply and in particular the prospect of inadequate stocks to maintain supplies in a 1 in 50 Severe Winter for domestic customers.

It is important to note that the industry has put a significant amount of collective effort in working up the details of this proposal, especially in regard to procedural matters associated with calculation and reconciliation of SWCQ values. It is recognised that this proposal may represent an interim solution in anticipation of longer term moves to abolish the Storage Monitor concept. Nevertheless it is vital that the current perverse incentives to withdraw gas from storage ahead of an emergency are removed and shippers are protected from being unfairly penalised from being unable to withdraw gas from store in such an emergency.

Modification proposal 0052 is a workable pragmatic solution to these fundamental concerns and we would urge the UNC Panel to recommend its approval.

Yours sincerely

Peter Bolitho
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