

The Joint Office, Relevant Gas  
Transporters and other interested  
parties

Our Ref:UNC/Mod/052  
Direct Dial: 020 7901 7389  
Email: [steve.smith@ofgem.gov.uk](mailto:steve.smith@ofgem.gov.uk)

2 December 2005

Dear Colleague

**Uniform Network Code modification proposal 052 “Storage Withdrawal Curtailment Trade Arrangements in an Emergency”**

Ofgem<sup>1</sup> has considered the issues raised in the modification report in respect of modification proposal 052 “Storage Withdrawal Curtailment Trade Arrangements in an Emergency” and having regard to the principal objective and statutory duties of the Authority<sup>2</sup>, has decided to direct the relevant gas transporters to implement modification proposal 052.

On balance, Ofgem considers that modification proposal 052 would better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11<sup>3</sup> of the relevant gas transporters’ licences as compared with the existing provisions of the UNC. Ofgem also considers that modification proposal 052 would be consistent with its wider statutory duties.

Although Ofgem has approved this modification, we consider that the Safety Monitor arrangements should be urgently reviewed and that further revisions to these arrangements, which are capable of implementation for this winter, should be considered and developed in a transparent manner as a matter of urgency.

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

---

<sup>1</sup> Ofgem is the Office of the Gas and Electricity Markets Authority. The terms ‘Ofgem’ and the ‘Authority’ are used interchangeably in this letter.

<sup>2</sup> Set out in Section 4AA of the Gas Act 1986, as amended.

<sup>3</sup> This Licence Condition can be viewed at: [http://62.173.69.60/document\\_fetch.php?documentid=6547](http://62.173.69.60/document_fetch.php?documentid=6547)

## Background to the proposal

In this section we set out a brief background of the recent developments in the gas industry which led to E.ON UK raising modification proposal 052.

### *Safety Monitors*

Safety Monitors were introduced after the removal of the top up arrangements, following the approval of modification proposal 710 “Removal of Top-up arrangements” in October 2004. The background to the removal of the top arrangements can be found in Ofgem’s recently published decision letter on modification proposal 035 “Revisions to Section Q to Facilitate the Revised National Emergency Coordinator (NEC) Safety Case”<sup>45</sup>.

There is now an obligation on National Grid National Transmission System (NG NTS) to publish two monitor levels, aggregated by storage facility type i.e. short, medium or long duration storage, by 1 October in each gas year. The “Firm Gas Monitor” covers the total firm demand and is published for information only. The “Safety Monitor” covers those sectors of demand defined in NG NTS’s Safety Case (including priority firm daily metered customers and non-daily metered customers). The purpose of the Safety Monitor is to ensure safety of the system to protect those customers that cannot be protected by physical isolation and thereby protect public safety in the event of an emergency following a shortfall of gas.

Following the publication of the monitor levels, NG NTS keeps under review the information upon which the monitors have been calculated. Since the approval of modification proposal 050 “Storage Monitor Adjustment”, NG NTS has the ability to:

- ◆ reallocate the Safety Monitor and/or the Firm Gas Monitor between storage facility types in order to enhance the security provided by current storage stocks;
- ◆ reduce a Safety Monitor and/or a Firm Gas Monitor to reflect changes in longer-term demand forecasts;
- ◆ adjust a Safety Monitor and/or Firm Gas Monitor to reflect the occurrence of severe weather; and
- ◆ increase or reduce a Safety Monitor and/or Firm Gas Monitor to reflect any material changes in its estimates of expected deliveries to or offtakes from the system.

NG NTS publishes periodic information in relation to each storage facility type, highlighting the risk of a breach of its associated Safety Monitor, within operational timescales. If NG NTS is aware that

---

<sup>4</sup> The decision letter for modification proposal 035 can be found on the Gas Transporters information service (formerly known as Nemisys)

[https://gtis.gasgovernance.comwww.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9030\\_710D.pdf](https://gtis.gasgovernance.comwww.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9030_710D.pdf)

<sup>5</sup> Although National Grid acts in the capacity of National Emergency Coordinator, as defined within the Gas Safety (Management) Regulations 1996 this role involves different duties, requiring a separate Safety Case to that held by National Grid acting as the National Transmission System operator.

the Safety Monitor levels have been, or are forecast to be, breached, then NG NTS will liaise with the NEC prior to the NEC declaring a Network Gas Supply Emergency (NGSE).

### *Changes to the NEC Safety Case*

Following the introduction of the Safety Monitor arrangements, the Health and Safety Executive (HSE) stated that it wanted these arrangements to be outlined and demonstrated in the NEC Safety Case. NG NTS considered that in a Safety Monitor Breach emergency, it would be inappropriate to allow gas to continue to flow from the affected storage facility/facilities. Therefore, NG NTS submitted a revised NEC Safety Case to the HSE. This included a new type of emergency - a Gas Safety (Management) Regulations or GS(M)R Monitor Breach Emergency - during Stage 1 of which the NEC can instruct shippers and storage operators to amend storage flows. The revised NEC Safety Case was accepted by the HSE in March 2005.

### *National Grid's Winter Outlook Report (WOR) 2005*

As part of its May 2005 Preliminary WOR<sup>6</sup>, NG NTS published indicative Safety Monitor levels under two scenarios. In the light of feedback on the consultation document and its view of the impact of the supply shocks caused by a potential increase in demand for Liquefied Natural Gas (LNG) in the United States on account of Hurricanes Katrina and Rita, NG NTS revised its Safety Monitors, as outlined in the Final WOR<sup>7</sup>. The table below shows the Safety Monitor levels for 2004/05 as well as the monitor levels for 2005/06.

<b>Storage type</b>	<b>Preliminary WOR 2005/06</b>		<b>Final WOR 2005/06</b>	<b>Final WOR 2004/05</b>
	<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Base case</b>	<b>Base case</b>
Long duration storage (Rough)	6.2%	17.2%	22.9%	6%
Medium duration storage (MRS)	5.0%	12.1%	12.7%	5%
Short duration storage (LNG)	18.2%	54.4%	26.4%	15%

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

<sup>6</sup> 'A Consultation on Winter 2005/06', NG, May 2005 available at: [http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/11584\\_14405b.pdf?wtfrom=/ofgem/whats-new/archive.jsp](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/11584_14405b.pdf?wtfrom=/ofgem/whats-new/archive.jsp)

<sup>7</sup> 'Winter Outlook Report 2005/06', NG, October 2005 available at: [http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12493\\_214\\_05.pdf?wtfrom=/ofgem/whats-new/archive.jsp](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12493_214_05.pdf?wtfrom=/ofgem/whats-new/archive.jsp)

## Cash out arrangements

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<sup>8</sup>. 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). Cash out prices are designed to reflect the costs that NG NTS incurs in buying and selling gas to balance the system each day.

## Modification proposal

Modification proposal 052 “Storage Withdrawal Curtailment Trade Arrangements in an Emergency Storage Monitor Adjustment” was raised by E.ON UK as an urgent proposal on 7 October 2005. Ofgem granted Urgent status to modification proposal 052 on 10 October 2005. The modification proposal seeks to leave shippers financially neutral if storage withdrawal curtailment is undertaken by the NEC. In order to do this, for each day affected by storage withdrawal curtailment, the modification proposal seeks to:

- ◆ define a Storage Withdrawal Curtailment Quantity (SWCQ), which is the quantity of gas that could have been reasonably nominated for delivery at relevant Storage Connection Points in the absence of NEC initiated storage withdrawal curtailment; and
- ◆ enable affected shippers to acquire their portion of the overall SWCQ from the NG NTS at a neutral price, namely the 30 day average of the System Average Price (SAP), via an SWCQ Trade.

The modification proposal is intended to ensure that a shipper’s imbalance position is unaffected by any storage curtailments. Each shipper’s SWCQ Trade is intended to match the nominated volume of storage withdrawal that it has been unable to access. As a result, an affected shipper would not face exposure to cash out for any difference between its delivery onto and offtakes from the system directly linked to the curtailment of storage withdrawals (e.g. a shipper with a short position prior to any storage curtailment would retain the same short position following storage curtailment).

## Respondents’ views

This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received.<sup>9</sup>

11 responses were received in relation to modification proposal 052. Of these responses, seven supported the modification proposal, two offered qualified support and two were opposed to the modification proposal.

---

<sup>8</sup> That is, in each 24 hour period beginning at 6am each day.

<sup>9</sup> Respondents’ views can be found on the Gas Transporters information service (formerly known as Nemisis) <https://gtis.gasgovernance.com>

## *Respondents supporting the proposal*

### *Price*

The Proposer considered that the 30 day average SAP would reflect a fair value for any SWCQ Trade taking into account the value of gas still held in store by the shipper. This view was shared by another respondent who considered that the SWCQ Trade should be charged at a broadly neutral price, believing that the most appropriate price was that of the 30 day average SAP.

### *Flexible gas*

The Proposer was of the view that the NEC's ability to curtail storage withdrawals unduly discriminated against storage as a peak form of flexibility compared to substitute forms of peak flexibility such as beach swing or demand reduction. This view was shared by a number of respondents supporting implementation of the modification proposal. One respondent noted that the existing arrangements discriminated against shippers who had elected to hold gas in store as a source of flexibility. This respondent considered that the modification proposal recognised, to some degree, the value of gas in storage and therefore better aligned the commercial incentives on all Users accessing flexible gas supplies from whichever source they wish to contract.

A further respondent noted that the amendments approved to the NEC Safety Case earlier this year could result in shippers being prevented from accessing their storage flexibility when they most needed it. This respondent considered it was not acceptable that parties with gas in store should be placed in a position whereby they underwrite security of supply for all customers without compensation for being unable to access their gas. This respondent was of the view that the proposal would go some way to mitigating the risk of shippers' gas in store being stranded and therefore considered that there was merit in the proposal being implemented as soon as possible.

### *Addressing perverse incentives*

In the opinion of the Proposer, perverse incentives exist within the current regime, which encourage shippers rapidly to deplete stocks of gas in storage in the lead up to a possible gas emergency and these would be removed by this modification proposal. Several respondents offering support for the modification proposal agreed with this view, considering that its implementation would remove the perverse incentives on shippers to withdraw gas prematurely to avoid it being locked in store. These respondents were of the view that the likelihood of an emergency being declared would decrease if the proposal were implemented and the perverse incentives removed.

### *Financial exposure*

The Proposer stated that the aim of the modification proposal was to mitigate the financial exposure that shippers would face if they were prevented from withdrawing gas from store. Several respondents agreed that the modification proposal would achieve this aim and were supportive of it.

One respondent who offered qualified support for the modification proposal noted they had sympathy for the principal that shippers who were unable to use their gas in storage during an

emergency should be protected from exposure to the marginal cash-out price. However, this respondent expressed concern that the SWCQ process may be open to gaming, which could disadvantage shippers collectively through neutrality.

The other respondent offering qualified support for the proposal considered that where a Stage 1 emergency continued for a number of days, certain shippers may nominate the maximum gas out of storage which would allow them to balance a portion of demand at 30 day average SAP. The respondent noted that the proposal would allow shippers to use gas in storage to balance 'virtually' during the emergency, and then use the same gas to balance physically after the emergency, effectively using the same gas to balance twice. In addition, shippers with gas in storage would nominate 'virtual' gas which would not help balance the system physically, with NG NTS having to make up the physical balance and the associated costs being smeared among all shippers. This respondent outlined that, in terms of financial exposure, there would be a transfer from shippers with gas in storage to those without.

#### *Impact on storage*

The Proposer highlighted the potential for storage curtailment, in the absence of appropriate shipper compensation, to damage the prospect of further investment in storage capacity, which in turn may threaten longer term security of supply. The majority of respondents in support of the implementation of the modification proposal were of the view that the proposal would restore the value of storage, encourage investment into new and existing storage facilities, and ultimately benefit long-term security of supply. One respondent considered that implementation of the modification proposal would mean that the value of storage would no longer be unreasonably undermined and longer term investments in storage facilities would be forthcoming.

In line with this view, another respondent noted that if the modification proposal was not implemented, NG NTS's ability to revise Monitor Levels and curtail storage would continue to undermine confidence in peak provision of gas from storage. This, the respondent argued, affected the economic incentives to construct additional storage and, ultimately, for long-term security of supply.

#### *Safety Monitor requirements*

One respondent in support of the modification proposal commented that it was regrettable that the change made to the NEC Safety Case had undermined the key concept on which the removal of top-up rested. This respondent stated it recognised that storage provided a natural fit with the requirement to maintain reserves and would have an important role supporting the NEC in a Supply Emergency. However, this respondent was of the view that NG should renegotiate the provision of these services and not simply impose obligations on the owners, operators and users of gas storage facilities.

#### *Respondents against the modification proposal*

The two respondents (one of whom was NG NTS) who did not support implementation of the modification proposal were of the view that the proposal would weaken the incentives on shippers

to balance their own positions. One respondent noted this would result from shippers being able to adjust their imbalance positions via the SWCQ without having to make corresponding adjustments to their supplies or demands, given that NG NTS would partially be undertaking this provision on behalf of shippers. NG NTS was of the view that its residual gas balancing role would need to be expanded to cover these instances if the modification proposal was implemented.

NG NTS considered that in allowing each NGSE event to be considered separately, the proposal would allow shippers to seek relief from cash-out on a number of occasions, further weakening the incentives on shippers to balance. This respondent was also of the view that the modification proposal could provide an unduly discriminatory level of relief for certain shippers from the present cash out mechanism in the event of a Safety Monitor breach, at the expense of other shippers.

Both these respondents expressed concerns regarding the modification proposal's effects on price sensitive supplies and security of supply. One respondent was of the view that the option to nominate storage withdrawals on subsequent days would not help the UK attract gas supplies to potentially reduce the length of an emergency. NG NTS considered that the 30 day average SAP price may be too low, acting as a disincentive to Users to procure price sensitive supplies, which may affect security of supply.

### **Panel recommendation**

At the Modification Panel meeting held on 17 November 2005, of the 10 Voting Members present, capable of casting 10 votes, 9 votes were cast in favour of implementing modification proposal 052 "Storage Withdrawal Curtailment Trade Arrangements in an Emergency Storage Monitor Adjustment". Therefore, the Panel recommended the implementation of this modification proposal<sup>10</sup>.

### **Ofgem's view**

Having considered the views of respondents and the Panel, Ofgem considers that, on balance, modification proposal 052 would better facilitate achievement of the relevant code objectives compared to the existing provisions of the UNC.

As set out above, we consider that the Safety Monitor arrangements should be urgently reviewed and that further improvements to these arrangements, which are capable of implementation for this winter, should to be considered and developed in a transparent manner as a matter of urgency.

The reasons for Ofgem's decision in relation to modification proposal 052 are outlined in the sections below. Ofgem considers that it is appropriate to assess this proposal against relevant objectives (a) and (d).

---

<sup>10</sup> A Panel recommendation requires a majority vote from voting members at a quorate meeting of the Modification Panel.

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

*Addressing perverse incentives to withdraw gas from store*

Ofgem recognises that an effect of the revisions to NG NTS's Safety Case and the introduction of the concept of a GS(M)R Monitor Breach Emergency is to enable the NEC to curtail storage flows during Stage 1 of such an emergency. Under the existing arrangements, shippers do not receive compensation when the NEC curtails storage flows.

Ofgem agrees with the majority of the respondents that enabling the NEC to maximise or curtail storage in Stage 1 of a GS(M)R Monitor Breach Emergency without any form of compensation creates perverse incentives for storage users to withdraw gas in advance of a GS(M)R Monitor Breach Emergency. Ofgem believes that it was not possible for shippers to reasonably assess the likely levels of the Storage Monitors when taking commercial decisions surrounding the price and volume of gas to be held in store. Ofgem considers that the lack of compensation together with the lack of information concerning the likely Safety Monitor levels is unlikely to give appropriate incentives for the efficient and economic operation of the system, as these perverse incentives may increase the risk that the system will go into an emergency by encouraging faster run-down of storage stocks by shippers seeking to avoid having their gas trapped in storage.

Modification proposal 052 seeks to address this issue by providing compensation to those shippers whose storage withdrawals are curtailed in these circumstances. The compensation that would be paid under modification proposal 052 should help to reduce the perverse incentives to remove gas rapidly from store in the run up to an emergency. On this basis, Ofgem, therefore, considers that modification proposal 052 better facilitates the achievement of relevant objective (a). However, Ofgem considers that alternative forms and levels of compensation should be considered to further develop the arrangements in this respect. Ofgem considers that compensation based on 30 day average SAP may not be the most appropriate level of compensation. Ofgem believes that compensation should seek to reflect the difference in the value of gas in store at the time of curtailment and its value once the curtailment has been lifted. Furthermore, Ofgem believes that it may be more appropriate for compensation to be provided by a simple cash payment, rather than by relief from imbalance exposure.

It should further be noted that the compensation arrangements under modification proposal 052 also allow the affected shippers to retain title of the gas in store. As the shippers retain title to the gas, they are able to use the curtailed gas twice (i.e. "virtually" under the compensation arrangements and then physically once the emergency is resolved). As a result, shippers may have the incentive to seek to increase their nominated flows from storage during a period of curtailment to increase the relief from imbalance exposure without this actually impacting upon their title to the affected gas subsequently. However, despite these limitations, Ofgem considers that, on balance, this modification proposal does reduce the perverse incentives which exist under the present arrangements. Furthermore, this particular issue could be addressed by amending the compensation arrangements such that title of gas is transferred in the event of storage flow curtailment.



Although Ofgem accepts that compensation addresses these perverse incentives, there may be better forms and levels of compensation for affected shippers. For the reasons outlined below, there may be merit in compensating parties through a simple cash payment, rather than by a deemed trade which removes imbalance exposure, and for title to transfer for the curtailed volume of gas. In this context, Ofgem is aware of the existence of modification proposal 067 (“Compensation payments to Users whose gas flows are curtailed into the system following instructions received from the NEC”) and its decision in relation to modification proposal 052 is made without prejudice to the assessment of modification proposal 067.

#### *Impact on storage*

Ofgem also agrees with respondents that the NEC’s current ability to curtail storage withdrawals without any compensation may interfere with the operation of privately owned natural gas storage facilities because of the uncertainty it creates as to whether shippers will be able to access their stored gas. Given that curtailment can occur in Stage 1 of an emergency, when other aspects of the gas market may be operating normally, the value of storage products to shippers in respect of flexibility may be eroded if no compensation is provided to affected shippers. This may provide incentives for shippers to hold less storage than would otherwise be the case. In this case, storage stock levels would be closer to the Safety Monitor levels with the implication that a GS(M)R Monitor Breach Emergency may be more likely. These undesirable effects would be mitigated if affected shippers were to receive compensation for the curtailment of their storage withdrawals. Since modification proposal 052 provides a form of compensation, Ofgem considers that, in this respect, modification proposal 052 better facilitates the achievement of relevant objective (a).

A further potential implication on storage relates to the detrimental effects that this might have on investment in storage facilities in the longer term. If this occurs, reduced investment in storage facilities would be likely to have a negative impact on the efficient and economic operation of the pipeline system by reducing the number of potential sources of gas to balance the system. Again, the provision of compensation to affected shippers that modification proposal 052 would introduce should reduce the likelihood that investment in storage facilities would be adversely affected in the longer term by the NEC’s ability to curtail storage withdrawals. Therefore, Ofgem considers that modification proposal 052 better facilitates the achievement of relevant objective (a) in this respect.

#### *NG NTS’s residual balancing role*

Modification proposal 052 will expand the role of NG NTS as residual balancer during Stage 1 of a GS(M)R Monitor Breach Emergency because NG NTS would effectively have to take responsibility for balancing the positions of those shippers affected by storage curtailments. This has the potential to increase NG NTS’s role beyond the current scope of the residual gas balancer. This may raise overall balancing costs which are ultimately paid by customers. This concern could be addressed by compensating affected shippers by way of a cash payment if their storage flows are curtailed, rather than having their imbalance exposure removed. This would compensate shippers for their storage rights being curtailed but leave them with the responsibility to balance their position. Shippers could then choose to trade out this imbalance or leave it to NG NTS and be exposed to NG NTS’s costs through the imbalance cash out regime.

The extent to which NG NTS's role will expand because, as discussed above, the affected shippers retain title of the gas in store and so may have the incentive to seek to increase their nominated flows from storage during a period of curtailment to increase the relief from imbalance exposure without this actually impacting upon their title to the affected gas subsequently. This could exacerbate the increase in NG NTS's balancing role during periods of curtailment as it would have to take more actions to resolve the affected shippers' imbalance positions. As mentioned above, this could be addressed by amending the compensation arrangements such that title of gas is transferred in the event of storage flow curtailment.

It is important to note that the effects of the compensation arrangements and the associated level of balancing actions that NG NTS would have to take in its enhanced role would feed through to shippers via the neutrality charges. Ofgem notes that NG NTS suggested in its response that these costs could be significant. Obviously the relevant costs here are the incremental costs associated with NG NTS taking these balancing actions over and above the costs which would be incurred if shippers took these actions themselves via the market.

#### *Potential for gaming*

Ofgem notes some respondents' concerns regarding the potential for gaming of withdrawal nominations if modification proposal 052 is accepted. To some extent, Ofgem considers that the potential for gaming is likely to be limited – in the circumstances under which a GS(M)R Monitor Breach Emergency is likely to be called, it is reasonable to suppose that shippers would be nominating maximum withdrawal rates irrespective of whether or not the modification proposal is accepted. However, if the emergency persisted during a period when the supply-demand balance eased, then the potential for gaming might be more of a concern. For example, shippers might be able to switch withdrawal nominations to the type of storage facilities whose Safety Monitor has been breached from types of storage facilities where there has been no breach. To the extent that any such actions occurred, this would increase NG NTS's role in balancing the system further which, as discussed above, Ofgem considers would be undesirable.

Ofgem has powers under Standard Condition 3 of the gas shippers licence to take action in the event that a shipper is gaming the system in respect to storage nominations. In the event that evidence existed of shippers pursuing this conduct Ofgem would launch an investigation which could result in enforcement action being taken including a potential financial penalty.

#### *Ofgem's view in regard to relevant objective (a)*

To conclude, Ofgem considers that on balance modification proposal 052 would better facilitate the achievement of relevant objective (a). Ofgem considers that the potential detrimental effects of modification proposal 052 in relation to NG NTS's residual balancing role are outweighed by the benefits that will accrue both from reducing the incentives for participants to withdraw gas in the run up to an emergency and from enhancing security of supply by maintaining the value of storage for potential investors.

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

*Discrimination linked to curtailment of storage in Stage 1*

Ofgem considers that current lack of compensation for storage curtailments under an emergency may discriminate between competing sources of gas. Gas storage withdrawals are now subject to command and control under Stage 1 of an emergency whilst this is not imposed on other sources of supply such as LNG, beach gas or gas supplied through the interconnector until Stage 2. Ofgem considers that this difference in treatment could potentially discriminate unduly between competing sources of gas. Modification proposal 052 would effectively, from a commercial perspective, bring the treatment of storage supplies more in line with that of other gas supplies. Therefore, Ofgem considers that, in reducing the potential for discrimination against supplies of gas from storage versus other sources, this modification proposal would promote effective competition between the relevant shippers and suppliers.

Ofgem notes that one respondent considered that, in removing imbalance exposure associated with storage curtailment, modification proposal 052 would provide inappropriate relief from cash out for the affected shippers. Ofgem acknowledges that, by removing this imbalance exposure, modification proposal 052 weakens the incentives on affected shippers to balance if storage flows are curtailed. However, shippers would have booked storage capacity and placed gas in store in response to the commercial incentives created through imbalance exposure. At the time they made the decision to use storage to manage this risk rather than alternatives, shippers would have had to form a view about the risk that nominations to flow gas from storage would be curtailed under the Safety Monitor arrangements. In considering this proposal, Ofgem is persuaded that shippers could not have reasonably foreseen that the Monitor levels would be as high as the current levels. The Safety Monitors have only been in place for one year and although NG NTS publishes the methodology for determining the monitor levels, it affords NG NTS wide discretion in setting the level of monitors. The table on page 3 shows the significant changes in the monitor levels from last year to this year and the significant changes from indicative levels published in May 2005 and the final levels set in September 2005. Given this significant change and the fact the Storage Monitor arrangements only affect one source of flexibility, Ofgem thinks that in these specific circumstances it is appropriate to compensate shippers.

*Ofgem's view in regard to relevant objective (d)*

Overall, Ofgem considers that modification proposal 052 would better facilitate the achievement of relevant objective (d).

*Summary*

Therefore, for the reasons outlined above, Ofgem considers that, on balance, modification proposal 052 would better facilitate the achievement of the relevant objectives. The following section outlines ways in which the issues that Ofgem has identified with modification proposal 052 may be overcome.

## *Wider issues*

Ofgem considers that there are several shortcomings in relation to the Safety Monitor arrangements. To overcome these issues, Ofgem considers, as outlined in the decision letter for modification proposal 035, that the arrangements would benefit from a more fundamental review ahead of next winter. Further details regarding Ofgem's intention to launch a review are provided below, having first set out issues more relevant in the short-term.

In the short term, it is Ofgem's view that the Safety Monitor arrangements would benefit from further consideration by interested parties. In addition to the areas highlighted for attention in the decision letter for modification proposal 035, Ofgem considers that the following areas, which are more specifically related to the issues raised in modification proposal 052, would benefit from consideration<sup>11</sup>:

- ◆ **Nature of compensation for shippers.** Modification proposal 052 will introduce compensation which removes shippers' imbalance exposure related to storage curtailment via a deemed trade between affected shipper and NG NTS. Ofgem considers that, although this introduction better facilitates the relevant objectives of the UNC as opposed to the existing position, it may be more appropriate for affected shippers to receive financial payment should their storage flows be curtailed, with associated transfer of title for the gas, rather than having their imbalance exposure removed. This would ensure that the shippers retain the primary responsibility for balancing and appropriate commercial incentives to do so. Furthermore, Ofgem considers that it may be appropriate for any compensation mechanism associated with curtailment to reflect the difference in the value of gas in store at the time of curtailment and its value once the curtailment has been lifted.
- ◆ **Commercial incentives on NG NTS to manage costs.** Under the existing Safety Monitor arrangements, NG NTS does not incur any costs (or face any incentives to manage them efficiently) in relation to its requirements for a volume of gas to be held in storage or the curtailment of market participant's planned flows out of storage. Clearly, however, these actions are likely to impose significant costs on market participants. Ofgem considers that, by not being exposed to the costs of its actions in this respect, NG NTS may not have appropriate commercial incentives to operate the system in an economic and efficient manner. This may lead, for example, to NG NTS being too pessimistic in forecasting the likely supply/demand balance and over-estimating the monitor requirements. This set of arrangements contrasts to those in the electricity sector in which NG Electricity Transmission (NGET) has incentives to manage the cost of the services it requires to ensure it can undertake its role as System Operator (SO) and these appear to be working effectively.

Ofgem considers that, under a revised set of arrangements, NG NTS should have appropriate commercial incentives to procure any gas required to ensure safe run down of the system to protect customers efficiently. This would encourage NG NTS to consider

---

<sup>11</sup> The provision of these views does not fetter the Authority's discretion in relation to any future modification proposals on these issues.

alternative sources of gas to storage where they are cheaper. It might, for example, be more appropriate and efficient for NG NTS to contract with shippers for storage curtailment rights rather than to pay compensation to shippers that are arbitrarily affected. Under such an approach it might also be possible to overcome the objection to this modification proposal that affected shippers can use their curtailed withdrawals to balance their positions twice – first, “virtually” under the compensation arrangements and then physically once the emergency is resolved.

Therefore, Ofgem is of the opinion that there is merit in market participants, including NG NTS, considering these aspects of the Safety Monitor arrangements in the short term.

In the context of the longer term Safety Monitor arrangements, Ofgem expects to initiate a review shortly, which will focus on revisions which can be made ahead of next winter. This review process will call on input from all market participants, including NG NTS. Ofgem will highlight its timetable to market participants in the coming weeks.

### **Ofgem’s decision**

For the reasons outlined above, Ofgem has decided to accept modification proposal 052.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Smith', with several overlapping loops and a horizontal line at the bottom.

**Stephen Smith**  
**Managing Director, Markets**