



Global Markets & Investment Banking Group

21 November 2005

Mr. M. Berrisford
Joint Office of Transporters
Modification Panel Secretary

Response to UNC Modification Proposals 061 and 062

Thank you for the opportunity to respond to the above two modification proposals. Merrill Lynch Commodities (Europe) Trading Ltd (MLCE) has a number of concerns with these proposals and cannot support the implementation of proposal 061 and offer only limited support for 062.

UNC Modification 061

We consider that this proposal is not well thought out, and the implications arising from its implementation will be detrimental for the traded market.

The development of a gas balancing alert to reflect the gross supply and demand conditions may appear to be a useful tool for the market to understand potential stress on the system and for some parties not actively monitoring the market this could provide a rough guide. However, in the context of this modification, the alert will be used as a trigger to allow National Grid Gas (NGG) to undertake 'off-market' trades.

We are not entirely sure which companies NGG will undertake trades with on the OTC, as the limit to non-OCM parties seems arbitrary, possibly discriminatory and very likely to be in breach of normal market practice of taking the best price available. It will be difficult to assess whether NGG is taking offers in price order as it will have to determine which parties are non-OCM participants. Further, it is not clear whether there will be a prohibition on companies setting up as non-OCM shippers to take advantage of any arbitrage opportunities.

The most significant problem from this proposal arises out of price reporting. By undertaking OTC actions most the market is not made aware of the cash out consequences for some time.

If a GBA is issued, we would expect that the sell side of the market will initially reduce in activity as the GBA is a strong buy signal and the price outcomes are less certain. In addition, the complexity of the 'price focussing' methodology

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based on a probability of use will only further signal an uncertain price increase in the market where such a price bears no resemblance to the marginal cost of gas. There appears no possible way that NGG could meet its 'efficient and economic' test if it were to buy gas without having any reasonable prospect of using it for residual balancing purposes.

The nature of the proposal is overly complex and unsuitable for a market that relies on active trading to determine marginal prices. By encouraging NGG to transact in the OTC market without effective and objective tests and immediate price reporting, the proposal dismisses the role of the market in managing primary gas balancing. We are concerned that this type of activity is still viewed as residual balancing activity when it clearly is not.

The proposal would encourage NGG to undertake more primary balancing actions. These primary balancing actions will not be as efficient as those undertaken by market participants because NGG does not have the same commercial drivers. Further, we may see a repeat of the problems in the electricity market where primary actions can crowd out other market participants.

It would be disappointing if the concept of residual balancing was sacrificed to solve an issue related to demand side participation in the market. We firmly believe that demand side participation in the market can be enabled through the existing OCM mechanism. Far better options exist to encourage the development of an OCM strip, the removal of complex probability calculations and possibly an obligation on suppliers to post customers demand side offers on the market. Additionally, any demand side offers on the OCM should be available to all market participants to hit, because this is the way an efficient market determines the marginal cost of gas and hence the cost of residual balancing.

We believe that the basic market concepts already exist to bring demand side players into the gas balancing equation. MLCE is concerned that these basic concepts would be distorted or abandoned by this modification as NGG will only undertake OTC trades with a limited number of market participants and price transparency will disappear at a time when it is most required. It is inconceivable that proposals should be introduced that will curtail trading activity during apparent times of system stress.

UNC Modification 062



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As noted above, the introduction of a gas balancing alert may have some merit for parties not actively analysing the market. But there are some important considerations with the development of such an alert.

First, the GBA is an estimate of system stress that does not take into account (unknown) contractual flexibility elsewhere on the system, and does not consider the overall current state of the system. As a gross measure it may provide a broad indication, but cannot replace a proper analysis of supply demand fundamentals. The quality of the measure could only be tested over time.

Our main concern is that the introduction of a GBA may be viewed as a sufficient measure of market transparency when we believe that further information is required by active market participants. We would be disappointed if the GBA were viewed as a proxy for providing better information as envisaged in mod 006. To be clear, the GBA does not provide any additional information to the market, it simply provides a calculation not all parties were performing for themselves.

We could only support the introduction of a GBA if there is some continual assessment of its value for indicating actual balancing problems, and if there is an indication that its introduction does not mitigate the need to improve information transparency in the UK market.

In conclusion, we can only offer conditional support for modification 062, and can not offer any support for modification 061 as it will be detrimental to the traded market, create prices unrelated to the marginal cost of gas and move the UK back to a Continental approach of primary gas balancing by the TSO.

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