

The Joint Office, Relevant Gas
Transporters and other interested
parties

Our Ref: UNC/Mod/071/071A
Direct Dial: 020 7901 7389
Email: steve.smith@ofgem.gov.uk

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Dear Colleague

Uniform Network Code modification proposal 071 “User Compensation for NEC Storage Curtailment” and Uniform Network Code modification proposal 071A “User Compensation for NEC Storage Curtailment (Alternative)”

Ofgem¹ has considered the issues raised in the modification reports in respect of Uniform Network Code (UNC) modification proposal 071 “User Compensation for NEC Storage Curtailment” and UNC modification proposal 071A “User Compensation for NEC Storage Curtailment (Alternative)” 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 071A. This decision also means the Authority has decided to direct the relevant gas transporters not to implement modification proposal 071.

Ofgem considers that modification proposal 071A would better facilitate the achievement of the relevant objectives of the UNC, as set out under Standard Special Condition A11³ of the relevant gas transporters’ licences as compared with the existing provisions of the UNC and modification proposal 071. Ofgem also considers this decision to be consistent with its wider statutory duties.

In this letter, Ofgem outlines the modification proposals, summarises respondents’ views to the modification report and gives reasons for its decision.

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 This licence condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547

The modification proposals

The background to these modification proposals is set out in Ofgem's decision letter in respect of approved modification 052⁴. Approved modification 052 provides a form of compensation which leaves shippers financially neutral in respect of cash out if storage withdrawal curtailment is undertaken by the National Emergency Coordinator (NEC). Although Ofgem considered, on balance, that approved modification 052 would better facilitate the achievement of the relevant objectives of the UNC, in the decision letter Ofgem highlighted a number of issues that were considered to merit further consideration, including the nature of compensation for shippers affected by storage withdrawal curtailment and the creation of commercial incentives on NG NTS to manage the associated costs. It should be noted that Ofgem's decision to approve modification proposal 052 and the comments included in that decision letter are without prejudice to Ofgem's discretion in considering modification proposals 071 or 071A.

Modification proposal 071

Modification proposal 071 "User Compensation for NEC Storage Curtailment" was raised by National Grid National Transmission System (NG NTS) as an urgent proposal on 9 December 2005. Ofgem granted urgent status to modification proposal 071 on 12 December 2005 for the reasons set out in the urgency decision letter⁵, which included enabling the modification proposal, if implemented, to be in place ahead of the Christmas period when, assuming that appropriate incentives exist, gas may be available for injection into store.

The modification proposal seeks to remove the Storage Withdrawal Curtailment Quantity (SWCQ) Trade introduced by modification proposal 052, and in its place introduce a storage curtailment compensation payment which would be calculated as follows:

$$\text{SAP} - (\text{ASSAP} + 0.0611\text{p})$$

Where:

- ◆ ASSAP (Average Summer System Average Price) = the volume weighted average of the end of Gas Day SAP prices between 1st April and 30th September inclusive in the previous Gas Year.
- ◆ 0.0611p is the minimum differential between System Marginal Price Buy (SMP Buy) and System Marginal Price Sell (SMP Sell) currently within UNC Section F 1.2, and was originally intended to reflect the costs of transferring gas in and out of storage.

Modification proposal 071 is intended to ensure that users are adequately compensated for any gas curtailed by the NEC during an emergency while at the same time retaining the appropriate

⁴ Ofgem approved implementation of modification proposal 052 "Storage Withdrawal Curtailment Trade Arrangements in an Emergency" on 2 December 2005. The decision letter for modification proposal 052 can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>

⁵ The urgency decision letter for modification proposal 071 can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>

incentives for Users to balance their portfolios on the day. It is proposed that title to the gas curtailed from storage would be retained by the user, available for use at a later date. The storage curtailment compensation payment is therefore intended to reflect the cost of placing gas in storage, of holding gas in storage and of delivering gas to the NBP.

In addition, modification proposal 071 introduces a cap on the volumes of gas for which compensation is payable. This cap is equal to the volume of gas the user has in the relevant storage facilities when its withdrawals are first curtailed plus any volumes subsequently injected into those facilities minus any volumes subsequently withdrawn and minus any volumes for which compensation has already been paid.

Modification proposal 071A

Modification proposal 071A “User Compensation for NEC Storage Curtailment (Alternative)” was raised by E.ON UK as an alternative to modification proposal 071 on 15 December 2005. As an alternative proposal, modification proposal 071A has followed the same urgent timetable as the original modification proposal 071.

Modification proposal 071A seeks to ensure that the valuation of gas in store following curtailment by the NEC during an emergency reflects the wholesale price of gas at the time users are able to regain full rights to withdraw gas from store. The proposal introduces a two stage approach. First, the Storage Curtailment Quantity Compensation value established by modification proposal 052 would be retained, but as a direct compensation payment rather than via the current imbalance adjustment mechanism. This compensation payment would subsequently be adjusted to take into account the value of the gas left in storage after the emergency had ended. The overall effect would be that the following storage curtailment compensation payment would be made to affected parties:

SMP Buy – (Post Emergency 30 day SAP + 0.0611p)

Where:

- ◆ Post Emergency 30 day SAP = the value of the arithmetic mean of the first 30 consecutive days of normal market operations following a Network Gas Supply Emergency or series of Network Gas Supply Emergencies.

Modification proposal 071A imposes the same cap as that envisaged by modification proposal 071 on the volumes of gas for which compensation may be payable.

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.⁶

⁶ Respondents’ views can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>

Thirteen responses were received in relation to modification proposal 071. Of these responses, two supported the modification proposal and eleven were opposed to the modification proposal.

Eleven responses were received in relation to modification proposal 071A. Of these responses, three supported the modification proposal, one offered qualified support and seven were opposed to the modification proposal.

Process concerns

A number of respondents to both modification proposals expressed concerns that these modification proposals had been progressed through the process under urgent timescales. A number of respondents opposed to the implementation of modification proposal 071 and modification proposal 071A agreed with the view held by one respondent who noted that, while there were areas of merit in the proposals, they could have benefited from further development. Several respondents considered that the baseline currently in place as a result of the implementation of modification proposal 052, whilst not perfect, was fit for purpose for winter 2005/06. As a result of these concerns several respondents, although broadly supportive of the underlying principles, felt that they could not support implementation of modification proposal 071 or modification proposal 071A (which several considered to be preferable to modification proposal 071) at this time and indicated their preference for developments in this area to be considered in more detail post winter.

Respondents supporting modification proposal 071

Basis of compensation payment

The Proposer considered that using SAP as the basis for any storage curtailment compensation payment would be appropriate given that users on average should be able to trade at SAP on the day. The Proposer also considered that using the average summer SAP would provide a clear ex-ante level of compensation, allowing users the ability to respond in real time.

Incentives to balance

The one respondent other than the Proposer in favour of modification proposal 071 was of the view that shippers should remain incentivised to physically balance their positions once an emergency has been declared. However, this respondent considered it was not appropriate to fully or over compensate Users to ensure that the incentive for shippers to balance was maintained.

Other

The Proposer noted that given that all compensation payments would be made out of balancing neutrality, all users would benefit from the certainty provided by the proposed arrangements. The other respondent in support of modification proposal 071 also considered that it would help prevent potential reliance on virtual balancing while also reducing the smearing of costs through balancing neutrality.

The Proposer considered that the simplicity of process of modification proposal 071 as compared to the alternative modification proposal 071A would ensure that affected users were provided with certainty regarding anticipated payments. The Proposer considered that settling the compensation issue within one business day as opposed to a period of at least a month would discourage inappropriate behaviour and the uncertain indebtedness positions of some users.

Respondents against modification proposal 071

Basis of compensation payment

The majority of respondents opposed to the implementation of modification proposal 071 considered that the proposed compensation arrangements would undervalue the gas that would have been available to the user had the NEC not undertaken emergency curtailment. Respondents were generally of the view that any compensation payment must include the marginal price of gas on the day an emergency ceases if it was to properly reflect the exposure that the user would be subject to should the gas not be available to address any imbalance position. A number of these respondents noted that it was not clear that the basis of the proposed payment (i.e. SAP) would adequately compensate for the opportunity costs of not using storage and having to source alternative supplies.

One respondent was of the view that a compensation mechanism that attempted to reflect both the value of gas curtailed on the day, and the past or future volume of such gas, was an over complication and one that would never produce the right value. This respondent was also of the view that adopting a one size fits all approach to compensation would be likely to lead to discrimination between holders of storage capacity at different facilities, given the differing withdrawal and injection characteristics.

Another respondent opposed to implementation of modification proposal 071 considered that using an average summer SAP as the minimum value of that gas in store was incorrect because some users may have injected gas outside the summer months, which would be expected at facilities with fast cycling rates, or on the highest priced days in the summer period.

One respondent opposed to the implementation of the proposal noted that they were supportive of the element of the proposal that would ensure users did not inappropriately receive compensation for the same volume of gas on more than one occasion. Several respondents also expressed concern that failure to adequately compensate the curtailed storage would devalue storage products and may make future storage investment uneconomic. A further respondent opposed to implementation of the proposal noted that while compensation arrangements incorporating SMP Buy may not be precisely correct, it would be more appropriate than the proposed use of SAP.

Incentives to balance

Several respondents opposed to modification proposal 071 were of the view that implementing a mechanism that did not provide adequate levels of compensation to users for gas curtailed during an emergency would reintroduce the perverse incentives that modification proposal 052 sought to remove, namely, the incentive to prematurely withdraw gas stocks from storage in the lead up to an

emergency. These respondents considered that the re-creation of these perverse incentives would increase the risk of an emergency occurring, thereby threatening security of supply.

One respondent noted that it was because of the conflicting issues and incentives surrounding the proposed compensation arrangements, that they believed modification proposal 071 should be rejected. This respondent was of the view that the proposal would place another questionable incentive on users if the difference between being compensated and not being compensated was greater than the cost of withdrawing and re injecting gas into storage.

Other

Two respondents opposed to modification proposal 071 were concerned that the implementation of compensatory cash payments, as opposed to reduced imbalance exposure, in uncertain timeframes may increase the credit risks faced by shippers, which could lead to increased costs borne by consumers. This view was also put forward by these respondents in respect of modification proposal 071A. This view was shared by another respondent who considered that failure to fully and fairly compensate users for storage curtailment under modification proposal 071 could easily contribute to business failures that might otherwise have been avoided.

One respondent not in support of modification proposal 071 expressed concern that the current incentives on storage users to cycle gas in store would be weakened by implementation of the proposal, either through uncertainty created by it, or through any unintended consequences not recognised given the short consultation period. This respondent also considered this view relevant to modification proposal 071A.

Another respondent opposed to implementation of modification proposal 071 noted that they did not agree with the Proposer that the proposal would maintain efficient levels of residual balancing activity and that it was likely that the proposal would exacerbate those actions taken to correct premature withdrawal actions.

Respondents supporting modification proposal 071A

Price

The Proposer considered that modification proposal 071A would provide full and fair compensation to shippers who find they are less able to balance their positions in an emergency. In the opinion of the Proposer, the post emergency adjustment to compensation would reflect the value of the volume of gas curtailed during an emergency that a shipper continues to hold in store following an emergency, based on post emergency wholesale prices. The Proposer also considered that retaining reference to SMP Buy in the compensation calculation would ensure that affected Users would not face high exposure to the imbalance cash-out price given the large difference between SMP Buy and SAP.

The Proposer's view was shared by one respondent offering support for modification proposal 071A who noted that any fair compensation payment that was designed to keep a User's financial position whole as a result of NEC actions would need to make reference to a User's likely imbalance cost i.e.

SMP Buy. This respondent also considered that any valuation of gas in storage must consider the market price a User could get for the withdrawal of their gas immediately following the end of an emergency i.e. post emergency 30 day SAP.

The Proposer was of the view that it was appropriate to use a market related value in the compensation arrangements which would ensure that Users would be paid different values of compensation depending on the time of year an emergency ceases. This view was shared by another respondent in favour of modification proposal 071A who further noted that the time of year that a shipper regains control of their gas would need to impact on the level of compensation.

Incentives to balance

The Proposer was of the view that modification proposal 071A would avoid inappropriate smearing of costs across all shippers where this was not justified, which may reduce any indirect impact on shippers' incentives to balance. The Proposer considered that by providing full and fair compensation, the modification proposal would encourage shippers to maintain adequate levels of gas in store to maintain supplies to customers.

A respondent other than the Proposer who offered support for implementation of modification proposal 071A noted that the proposed arrangements for calculating the curtailment quantity would provide greater clarity than the current arrangements, while also avoiding the potential double counting of curtailed gas in storage and so the potential for users to be compensated more than once for the same volume of gas. This view was shared by the respondent offering qualified support for the proposal who agreed that the proposed compensation calculation would limit the volume of gas a User could claim for.

The respondent who offered qualified support for modification proposal 071A considered that the proposal did not distort the incentives for keeping gas in store, effectively retaining a similar amount of compensation where users are protected against SMP Buy prices as introduced by modification proposal 052.

This respondent further considered that any failure to ensure adequate compensation was made available would threaten security of supply as shippers would be perversely incentivised to deplete stocks faster than normal in order to at least withdraw their gas during winter as opposed to at the end of winter.

Respondents against modification proposal 071A

Five of the seven respondents opposed to the implementation of alternative modification proposal 071A also opposed the implementation of modification proposal 071.

The remaining two respondents opposed to the implementation of alternative modification proposal 071A were of the view that using SMP Buy as a base price would over compensate the majority of Users. One respondent considered that while using SMP Buy may potentially provide increased incentives for Users to retain their gas in store, it would also have the effect of distorting the market in favour of those Users affected by storage withdrawal curtailment. This respondent also noted that

it was questionable whether using a post emergency 30 day SAP value as a proxy for the value of gas remaining in storage post emergency would be adequate, given that the volume of gas under the storage monitor could be withdrawn within as little as four days.

Panel recommendation

Modification proposal 071

At the Modification Panel meeting held on 21 December 2005, of the 7 Voting Members present, capable of casting 9 votes, 2 votes were cast in favour of implementing modification proposal 071 "User Compensation for NEC Storage Curtailment". Therefore, the Panel did not recommend the implementation of this modification proposal.

Modification proposal 071A

At the Modification Panel meeting held on 21 December 2005, of the 7 Voting Members present, capable of casting 9 votes, no votes were cast in favour of implementing modification proposal 071A "User Compensation for NEC Storage Curtailment (Alternative)". Therefore, the Panel did not recommend the 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 071 and 071A. As both modification proposals are seeking to address the same concerns, Ofgem has separately considered whether each of 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 duties, Ofgem considers that modification proposal 071A would better facilitate achievement of the relevant code objectives compared to the existing UNC baseline and modification proposal 071.

Ofgem acknowledges that modification proposals 071 and 071A have been progressed within a short timeframe and recognises the concerns raised by respondents on this issue. However, as outlined in the urgency decision letter, Ofgem considers that it was appropriate for modification proposal 071 to be progressed according to an urgent timetable given its potential impact on storage cycling and therefore potentially security of supply for the remainder of this winter.

The reasons for this decision are outlined below, based on Ofgem's assessment of the modification proposals against the relevant code objectives and the Authority's wider statutory duties. Ofgem considers that it is appropriate to assess these proposals against relevant objectives (a) and (d).

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

As outlined above, modification proposals 071 and 071A would change, but not remove, the compensation available to shippers whose storage withdrawals are curtailed during Stage 1 of a GS(M)R Monitor Breach Emergency. Ofgem considers that it is appropriate for some form of compensation to be paid to shippers whose gas withdrawals are curtailed. However, it is important to consider whether the proposed compensation payments would promote the efficient and economic operation of the system to a greater extent than the current compensation arrangements.

Most respondents to the consultation on modification proposal 052 indicated that the current compensation arrangements would provide an adequate level of compensation without removing all the incentives for participants to balance their positions. Further, the fact that parties have been re-injecting gas into storage since the current compensation arrangements were approved indicates that shippers have accounted for the fact that such arrangements are in place when considering their stored gas positions.

However, as indicated in Ofgem's decision letter on modification proposal 052, the current compensation based on 30 day average SAP may not be the most appropriate level of compensation. This is because the 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. Ofgem considers that modification proposal 071A is more consistent with this approach than modification proposal 071. This is because the final level of compensation paid under modification proposal 071A is related to the level of prices prevailing after the emergency has finished. Modification proposal 071 instead connects the level of compensation to the costs of putting gas into storage rather than the value of that gas once it is in store. Clearly, the costs of putting gas into store may bear little or no relation to the value of that gas once it is in storage. In this respect, Ofgem considers that modification proposal 071A would be likely to better facilitate the efficient and economic operation of the system whereas modification proposal 071 is not likely to do so.

Ofgem also holds further concerns that the compensation available to affected parties under modification proposal 071 would be insufficient to encourage further recycling of gas into storage. Any gas purchased for this purpose would be likely to cost significantly more than the average summer SAP. It is therefore likely that shippers would be reluctant to buy gas to put into storage if the value that could be assigned to that gas was significantly less than its cost and the prevailing value of gas, should their storage withdrawals be curtailed. Therefore, in this respect, Ofgem further considers that modification proposal 071 would not better facilitate the efficient and economic operation of the system.

Incentives to balance

Both of the modification proposals seek to provide compensation by a simple cash payment, rather than by relief from imbalance exposure. This is consistent with views noted by Ofgem in its decision letter for approved modification 052. In that decision letter Ofgem indicated that such a

compensation method may be more appropriate because it would have less impact on participants' incentives to balance.

Further, Ofgem notes that modification proposals 071 and 071A both provide parties with compensation for their storage use being curtailed but would leave shippers with the responsibility for balancing their positions. It would then be a commercial choice for shippers as to whether they trade out their imbalance or leave it to NG NTS and be exposed to NG NTS's costs through the imbalance cash out regime.

Ofgem notes the views of some respondents that modification proposal 071 will increase the incentives for participants to balance their own positions. These parties consider this to be the case because the level of compensation that would be paid under modification proposal 071 is likely to be lower than that which is available under the current arrangements, and also that which would be available under modification proposal 071A. While Ofgem agrees with these respondents that this is likely to be true when SAP is much lower than SMP Buy, this will not always be the case.

However, under modification proposal 071A, as the final level of compensation to be paid will not be known until 30 days after the end of the emergency, Ofgem notes that this element of uncertainty will also provide further incentives on parties to balance their positions.

Therefore, Ofgem recognises there are different elements of both modification proposals 071 and 071A that provide increased incentives for participants to balance their own positions.

NG NTS's residual balancing role

Ofgem notes that both modification proposals 071 and 071A would be likely to reduce the role of NG NTS as residual balancer during Stage 1 of a GS(M)R Monitor Breach Emergency. This is because both modification proposals provide compensation by means of simple cash payments rather than adjustments to participants' imbalance positions. Therefore, NG NTS would have reduced responsibility for balancing the positions of those shippers affected by storage curtailments. To the extent that both modification proposals reduce the role of NG NTS as residual balancer, this is likely to reduce the level of costs that NG NTS incurs as residual balancer that have to be smeared across all shippers via the neutrality charge.

Under the current arrangements, there is the potential for shippers to increase their nominated flows from storage during a period of curtailment to increase the relief from imbalance exposure. This is because shippers retain title to the gas in storage and there is no limit on the volumes of imbalance relief that they can claim. To the extent that such activities were to occur, NG NTS would need to take further balancing actions to address the imbalance, meaning an inefficient expansion of NG NTS's residual balancing role. As it is more likely that shippers would be able to more efficiently balance their own positions than NG NTS, this may raise overall balancing costs which are ultimately paid by customers.

Both modification proposals 071 and 071A address this concern to some extent because they both introduce a cap⁷ on the volumes of gas in storage for which parties can claim compensation. As such, any attempts by shippers to artificially inflate storage withdrawals during an emergency could leave them without any right to compensation during a later stage in the emergency or throughout a subsequent emergency. Therefore, while this element of both modification proposals is preferable to the current arrangements, Ofgem remains of the view that the most appropriate way of dealing with this issue would be for the title of the curtailed gas to be transferred to NG NTS.

Therefore, Ofgem recognises that both modification proposals 071 and 071A provide increased efficiencies due to a potential reduction in NG NTS's residual balancing role.

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

To conclude, for the reasons outlined above, Ofgem considers that both modification proposals 071 and 071A would better facilitate the achievement of relevant code objective (a). However, Ofgem considers that, on balance, modification proposal 071A would better encourage the efficient and economic operation of the pipe-line system and would therefore better facilitate the achievement of relevant code objective (a) as compared to modification proposal 071.

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

Modification proposal 071A links the level of compensation payable to those shippers whose storage withdrawals have been curtailed to the value that they should be able to obtain from selling the gas once the emergency has ended. Consequently, as the potential value that could be realised for the gas left in storage increases, the level of compensation paid decreases (all other things being equal). Ofgem considers that this linkage reduces the risk that can exist under the current arrangements for inappropriate cash out relief to be afforded to affected shippers.

By contrast, the linkage of the compensation payments to the average summer SAP under modification proposal 071 would discriminate against those parties who wished to buy gas later in the year to inject into storage. As such, the potential for shippers to receive inappropriate relief from cash out would remain.

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

Ofgem therefore considers that modification proposal 071A would better facilitate the achievement of relevant code objective (d) relative to both the current arrangements and to modification proposal 071.

⁷ This cap is defined in the same way in both modification proposals.

Summary

Therefore, for the reasons outlined above, Ofgem considers that, on balance, it has not been demonstrated whether or not modification proposal 071 would better facilitate the achievement of the relevant code objectives. However, it has been demonstrated that modification proposal 071A would better facilitate the achievement of the relevant code objectives.

Wider issues

While Ofgem notes that both modification proposals 071 and 071A address several of the shortcomings raised in its decision letter on modification proposal 052, it is of the view that some outstanding issues remain that need to be considered in relation to the Safety Monitor arrangements in the short term, such as the need to develop appropriate commercial incentives for NG NTS to manage the costs associated with gas safety reserve requirements. To overcome these issues, as outlined in the decision letter for modification proposal 035,⁸ Ofgem considers that the arrangements would benefit from a more fundamental review ahead of next winter. To this end, on 20 December 2005 Ofgem notified interested parties of its intention to initiate a review 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 be holding a seminar to discuss these issues on 16 January 2006 and invites all interested parties to register their interest to attend at wholesale.markets@ofgem.gov.uk.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to accept modification proposal 071A and reject modification proposal 071.

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



Stephen Smith
Managing Director, Markets

⁸ The decision letter for modification proposal 035 ("Revisions to Section Q to Facilitate the Revised NEC Safety Case") can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>