CODE MODIFICATION PROPOSAL No. 0071A
"User Compensation for NEC Storage Curtailment (Alternative)"
Version 1.0

Date: 15/12/2005

Proposed Implementation Date: 15 January 2005

Urgency: Urgent status granted by Ofgem on 12 December 2005

Proposer's preferred route through modification procedures and if applicable, justification for Urgency

It is anticipated that this alternative proposal would follow the same timetable as the original modification proposal 0071. Nevertheless the proposer of this alternative would have preferred that it, together with the original proposal, would have followed the non-urgent route. This would have allowed the industry more time to develop the most robust proposal capable of best addressing the perceived deficiencies of Modification 0052 identified in Ofgem's decision letter of 2 December 2005.

Nature and Purpose of Proposal (including consequence of non implementation)

In approving modification 0052 Ofgem stated in their decision letter;

"Modification proposal 0052 will introduce compensation which removes shipper' imbalance exposure related to storage curtailment via a deem 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 to receive financial payment should their storage flows be curtailed….."

They add;

"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."

E.ON UK as the proposer of Modification 0052, which this alternative proposal now seeks to amend, was of the view that both the form and level of compensation provided for under Modification 0052 was fit for purpose for winter 05/06 and that any necessary refinements would be best considered through a less rushed consultation process next spring.

We do however recognise that under certain circumstances the level of compensation offered under Modification 0052 may be inappropriate. Compensation may either be too great or too little depending on the value of the gas that a shipper continues to hold in store at the time the emergency ceases. Clearly this valuation of gas in store will be affected by the time of year the shipper regains control over its gas in store under post-emergency conditions.

Currently the cost of compensation is borne by the shipping community in general and any inappropriate, untargeted 'smearing' of such costs may ultimately affect how shippers act in the market. This may indirectly impact shipper incentives to balance.

Although NG NTS recognises that the core purpose of Modification 0052 is *"to ensure that Users whose storage withdrawals have been curtailed as a result of the actions of the NEC are kept whole",* their original proposal does not reflect this. In our view the original proposal would, more often than not, systematically under-compensate storage users. The E.ON UK alternative instead seeks to provide a more balanced solution that is demonstrably more 'cost reflective' because valuations of gas in store would reflect wholesale prices at the time shippers become fully able again to exercise rights to withdraw gas from store.

We agree with NG NTS that it is important that shippers should not be able to claim compensation for the same curtailment quantity during Network Gas Supply Emergencies. Modification 0052 only considered one continuous NGSE and as such did not foresee such multiple claims. Is difficult for us to assess how credible the scenario of multiple emergency curtailment periods described by NG NTS is, but we are happy to support this element of the NG NTS proposal to remove the identified anomaly. It is particularly appropriate that, 'opening stock' levels for each curtailment period reflect injections that may have taken place between curtailment periods.

Any failure to ensure that adequate compensation is made available to shippers who find themselves unable to use storage in an emergency will threaten security of supply as shippers will be perversely incentivised to deplete stocks of gas in store at faster rates than would otherwise be the case.

The Proposal

E.ON UK sets out below the changes it believes are necessary to NG NTS's original proposal. The elements of the NG NTS proposal we do not comment on should be assumed to form part of this alternative proposal.

The main purpose of Modification 0052 was to ensure, broadly speaking, that affected shippers are kept financially neutral to the storage withdrawal curtailment actions of the NEC during an NGSE. It was originally proposed because Modification 0044 *"Revised emergency cash-out and curtailment arrangements",* had radically changed the imbalance cash-out arrangements under emergency conditions. Allowing the NEC to exercise a 'free option' to curtail the use of storage under such circumstances was seen to be manifestly unreasonable and a major distortion to the market for 'peak gas flexibility'.

Of fundamental concern was the fact that without adequate compensation shippers could be perversely incentivised to withdraw gas from store earlier than might otherwise have been the case in the run up to a possible gas emergency for fear that their gas would be 'locked in store' by the NEC. This could bring forward an emergency or cause an emergency that might otherwise be avoided.

It was recognised in the development of Modification 0052 that the System Marginal Buy Price (SMP_{buy}) minus 30 day System Average Price compensation may not precisely offer the 'right' level of compensation to shippers adversely affected by storage withdrawal curtailment. Nevertheless the consensus amongst the shippers who helped develop the proposal in the workstream was that it was broadly acceptable and was certainly no more or less arbitrary than the price of Emergency Curtailment Quantity Trade transactions introduced under Modification 0044.

Unlike the NG NTS's original proposal this alternative seeks to provide **full and fair** compensation to shippers that find themselves less able to balance their positions in an emergency. With the approval of Modification 0052 the NEC may have lost its 'free option' to intervene as it sees fit in the market, but this should not mean that NG NTS should be allowed to rush through a proposal to replace a reasonably priced (i.e. Modification 0052) option with a 'cheap' option. It would seem that the best way to keep the cost of exercising such options down would be financial incentives on NG NTS. This would help dissuade the NEC from exercising storage curtailment, and the detrimental affect this has on the whole commercial balancing regime, the market for peak flexibility and the overall wholesale gas market. We trust that Ofgem will oblige NG NTS to bear a proportion of the costs of compensating shippers in future, rather than requiring the whole amount to be borne by shippers who will ultimately pass through these costs to customers.

E.ON UK's alternative proposal introduces a post emergency adjustment to the Storage Withdrawal Curtailment Quantity compensation[1] value established under Modification 0052, to reflect the value of gas in store.

To help avoid the possibility of business failures due to cash-flow/credit cover problems resulting form excessive imbalance exposures that might otherwise not immediately be offset by storage curtailment compensation payments, we propose that the initial 'up-front' (SMP_{buy} – 30 day SAP) compensation payment introduced under Modification

[1] In E.ON UK's view the actual form (rather than the value) of compensation makes no difference to incentives to balance. The financial impact on shippers is just the same. Our preference would however be to stick with the existing adjustment to a shippers balance position as this is easier for shippers to account for this through a trade process. It also explicitly records the NEC's intervention in the market rather 'hiding' this transaction in the form of a direct compensation payment. In our view it is extremely useful to record the adverse affect such actions have on shippers' ability to balance in the hope that the NEC will decide to avoid such intervention. Retention of the SWCQ Trade concept may also help facilitate design of an appropriate storage curtailment incentive mechanism.

0052 would be retained[2]. A reconciliation process would adjust the actual amount paid after the end of the NGSE.

If the value of gas in store post a NGSE were greater than the 30 day SAP then the shipper would pay the excess multiplied by the SWCQ for a given day back to the system (i.e. refunds would be made to all shippers via neutrality depending on their usage of the system on that day). If the value of gas in store post an emergency is less than the 30 day SAP then the shipper would get paid the shortfall from the system (i.e. additional payments paid by all shippers via neutrality depending on their usage of the system on that day).

The value of gas in store would be:

30 day SAP_{PE} - 0.0611p

Where

30 day SAP_{PE} = Post Emergency System Average Price over the first 30 consecutive Days of normal market operations following a Network Gas Supply Emergency or series of Network Gas Supply Emergencies. It is the value of the arithmetic mean of the System Average Prices determined under Section F1.2.1 (c) but by reference to the first 30 consecutive Days follow cessation of a Network Gas Supply Emergency.

Where there are no market actions from which to derive a SAP value for a given Day this value shall be excluded from the calculation. In effect if a SAP value could not be determined for one Day the averaging shall be based on SAP values over 29 Days instead.

0.0611p is the minimum differential between SMP_{buy} and SMP_{sell} currently set out within UNC Section F1.2. This was originally conceived in Network Code Modification 0433 as being representative of the cost of transferring gas into and out of storage.

[2] But subject to the direct compensation payment set out in NG NTS's original proposal, rather than the Modification 0052 imbalance adjustment process.

Comparison of Compensation Amounts paid under the NG NTS proposal and E.ON UK alternative proposal

Scenario 1 - A ‘rapid’ emergency ending in January

A ‘rapid’ emergency may result in a large difference between SMP_{buy} and prevailing SAP prices at the time the emergency is called. This example assumes the emergency ended at the end of January. With SMP_{buy} = £5/therm, SAP = £2/therm, 30 day SAP = £1.50/therm ASSAP = 30p/therm and 30 day SAP_{PE} = £2/therm then the position is as follows

Position	**Compensation**
Compensation pre 0052	£0 /therm
Compensation post 0052 based on direct imbalance exposure	£5 - £1.5 = £3.50/therm
Compensation offered under NG NTS proposal	£2 – 30p - 1.7p = £1.683/therm
Compensation offered under E.ON UK alternative	£5 – £2 – 1.7p = £2.983/therm

Scenario 2 – A ‘rapid’ emergency ending in April

If the ‘rapid’ emergency were to end at the end of April the prices could be SMP_{buy} = £5/therm, SAP = £2/therm, 30 day SAP = £1.50/therm ASSAP = 30p/therm and 30 day SAP_{PE} = 50p/therm then the position is as follows

Position	**Compensation**
Compensation pre 0052	£0 /therm
Compensation post 0052 based on direct imbalance exposure	£5 - £1.5 = £3.50/therm
Compensation offered under NG NTS proposal	£2 – 30p - 1.7p = £1.683/therm
Compensation offered under E.ON UK alternative	£5 – 50p – 1.7p = £4.483/therm

Scenario 3 – A 'progressive' emergency ending in January

A more progressive emergency may result in a relatively small difference between SMP_{buy} and prevailing SAP prices at the time the emergency is called. This example assumes the emergency ended at the end of January. With SMP_{buy} = £5/therm, SAP = £4.50/therm, 30 day SAP = £2.00/therm ASSAP = 30p/therm and 30 day SAP_{PE} = £2.00/therm then the position is as follows:

Position	Compensation
Compensation pre 0052	£0 /therm
Compensation post 0052 based on direct imbalance exposure	£5 - £2 = £3.00/therm
Compensation offered under NG NTS proposal	£4.5 – 30p - 1.7p = £4.183/therm
Compensation offered under E.ON UK alternative	£5 – £2 – 1.7p = £2.983/therm

Scenario 4 – A 'progressive' emergency ending in April

If the 'progressive' emergency were to end at the end of April the prices could be SMP_{buy} = £5/therm, SAP = £4.50/therm, 30 day SAP = £2.00/therm ASSAP = 30p/therm and 30 day SAP_{PE} = 50p/therm then the position is as follows

Position	Compensation
Compensation pre 0052	£0 /therm
Compensation post 0052 based on direct imbalance exposure	£5 - £2 = £3.00/therm
Compensation offered under NG NTS proposal	£4.5 – 30p - 1.7p = £4.183/therm
Compensation offered under E.ON UK alternative	£5 – 50p – 1.7p = £4.483/therm

It is clear that any fair compensation mechanism designed to keep shippers financial positions whole as a result of the actions of the NEC must make reference to a shipper's likely imbalance costs (i.e. the SMP_{buy} price). In addition it is reasonable to consider that any valuations of gas in store must consider the market price shippers could reasonably get for the withdrawal and sale of that gas in the period immediately following a NGSE. If this is in the winter compensation would necessarily be less, if in the summer compensation might be expected to higher.

Basis upon which the Proposer considers that it will better facilitate the achievement of the Relevant Objectives, specified in Standard Special Condition A11.1 & 2 of the Gas Transporters License

E.ON UK considers that this alternative Proposal, if implemented, will better facilitate the following relevant objective as set out in NG NTS's GT Licence:

In respect of paragraph 1.a): E.ON UK considers that this Proposal will improve *"the efficient and economic operation of the pipe-line system"* by avoiding inappropriate 'smearing' of compensation costs across all shippers where this is not justified, Inappropriate targeting of such costs may ultimately affect how shippers act in the market. This may <u>indirectly</u> impact shipper incentives to balance.

In respect of paragraph 1.e): E.ON UK considers that this Proposal will improve *"the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers"* by providing **full and fair compensation** to Users affected by a storage curtailment, it will encouraging such shippers to maintain adequate stocks of gas in store to maintain supplies to such customers.

In addition E.ON UK considers that the full and fair compensation to shippers affected by storage curtailment will help *securing effective competition between relevant shippers.*

Shippers will be encouraged to use other forms of perhaps less economic flexibility in preference to storage because they are not appropriately compensated for helping the system when the Emergency Procedures require shippers to keep gas in store. Ultimately this may help damage the prospect for further investment in storage capacity which the GB so desperately needs to support long-term security of supply.

Shippers are nevertheless acutely aware of their wider obligations to customers, which may lead them put a brake on how fast gas stocks are reduced. It would be wrong for prudent shippers who have chosen to rely heavily on storage capacity to meet peak supplies to customers to be unduly discriminated against, just because less prudent shippers have decided to withdraw gas from storage at much faster rates. By addressing the perverse incentive that penalises shippers from maintaining adequate stocks of gas in store, prudent shippers are less disadvantaged than before. Thus implementation of this proposal will promote greater and more effective competition in the shipping and supply of gas.

It is important to note that under a number of realistic emergency scenarios NG NTS's proposal will reintroduce the perverse incentives in the regime that were largely mitigated by the implementation of Modification 0052

The recent period of high gas prices has resulted in several shippers going out of business, in part because of their inability to cover their imbalance exposure. Failure to fully and fairly compensate shippers for storage curtailment could in future very easily contribute to further business failures that might otherwise be avoided. This may be considered to be detrimental to competition in shipping and supply.

Any further information (Optional), likely impact on systems, processes or procedures, Proposer's view on implementation timescales and suggested legal text

a. Proposed implementation timetable is as per original proposal.

b. Proposed legal text

The proposer requests that the relevant transporter produces the legal drafting for this alternative modification proposal promptly and preferably before the UNC Panel meeting. Please ensure the proposer has ample opportunity to consider legal drafting before implementation.

Code Concerned, sections and paragraphs

Transportation Principal Document

Section F - System Clearing, Balancing Charges and Neutrality 4.4.2 and 4.4.3

Section Q - Emergencies 4.2.2 and 7

Proposer's Representative

Christiane Sykes, E.ON UK

Proposer

Peter Bolitho, E.ON UK

Signature

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