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Mr. Julian Majdanski
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Dear Julian,

Re: Modification Proposal 0086: "Introduction of Gas Demand Management Reserve Arrangements"

E.ON UK does not support the implementation of this Modification Proposal 0086.

This proposal fundamentally alters the respective roles of NG and shippers in the market and we believe there are significant risks associated with extending NG's role beyond that of residual balancer. We consider that implementation of this proposal will weaken shipper balancing incentives and increase the chances of emergency procedures being invoked.

It is difficult for us to assess the full impact of this proposal because the modification proposal outlines few details with regard to the form and scope of any gas reserve tender, under what circumstances NG should exercise such contracts how cash-out prices may or may not be affected and from whom and how the costs of such arrangements should be recovered.

What is clear is that this proposal is causing much uncertainty in the market. Customers appear to be waiting for a decision on this proposal before they agree demand side contract terms with their suppliers. This could undermine shippers' readiness to respond to tight supply conditions next winter.

We urge the Panel not to recommend this proposal and for Ofgem to reject it both in principle as well as on grounds that the proposal is inadequately defined. We

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also ask Ofgem come to its decision as quickly as possible so that customers and shippers can agree demand side terms well ahead of the winter.

Our detailed comments are as follows:

Extent to which implementation of the proposed modification would better facilitate the relevant objectives

The Gas Transporter Licence Standard Special Condition A11.1

- (a) *the efficient and economic operation of the pipe-line system to which this licence relates;*

The efficient management of flows on the system is in part dependent on the accuracy of information provided by shippers to NG. The exercise of an option under this proposal appears to be no more than a 'title' transaction at the NBP, where it is impossible to ascertain the anticipated level of 'turn-down' by individual customers at particular locations.

It is also unclear how NG will be able to distinguish between demand side response under conventional demand side contracts and those that originate from their exercising gas reserve contracts. Would a "P70 style" notification process be required?

Without such clarity this proposal is no more than a 'paper' energy option contract that may or may not result in a physical change in consumption patterns. We concluded that the added uncertainty and complexity arising from this proposal will inevitably adversely affect the efficient and economic management of the system.

- (b) *so far as is consistent with sub-paragraph (a), the coordinated, efficient and economical operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant gas transporters;*

The problems outlined in (a) above are further exacerbated where distribution network operators inevitably need to be involved in the communication chain to ascertain whether or not a demand side response has or has not taken place.

- (c) *so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence;*

- (d) *so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition:*

- (i) *between relevant shippers;*
- (ii) *between relevant suppliers; and/or*
- (iii) *between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;*

This proposal will cause significant (multi millions of pounds) of financial redistribution between shippers and will thus profoundly affect competition between shippers and suppliers. Implementing this at short notice would simply advantage particular market participants at the expense of others. Disadvantaged parties would not have time to adjust their competitive positions ready for next winter, thus advantaged parties would make

'windfall' gains.

Under the current gas regime demand side response is essentially a tool to allow shippers to manage their own energy balance position, and thereby avoid potentially high imbalance cash-out prices in the event 'short' positions. Given the usefulness of this tool to shippers, why on earth would they wish to offer a fixed price exercise value at anything other than a very high price, bearing in mind there is theoretically no limit to the level of the system marginal buy price. One would expect prices to escalate rapidly ahead of a possible gas emergency.

Some shippers may be willing however, to offer more 'favourable' terms to NG under a gas reserve tender.

- (a) shippers that have no intention of honouring reserve contracts should imbalance prices become so prohibitively expensive that they exceed the exercise prices. Under such a situation such parties may simply choose to exit the market and no physical demand side response will result from NG exercising such contracts.
- (b) shippers whose customer portfolio is made up of mainly of large I&C customers who can provide demand side response, in which case their metered offtakes from the system would be low thereby avoiding most of the huge smearing costs they have 'caused' as a result of the exercise of theirs and others gas reserve contracts.

The key issue here is whether it is right for the 'opportunistic' actions of a few shippers (some of whom may make promises that they may not be able to fulfil to secure lucrative option fees) and place this cost burden on other shippers. We consider that this disproportionate cost burden arising from gas reserve contracts will inevitably have to be reflected in prices to smaller customers.

In addition, given that that contract for gas reserve is struck between NG and a shipper rather than a direct contract between NG and the customer it is also unclear to what extent the income from the option and exercise will actually be passed through to customers.

The gas reserve proposals **may** ensure large I&C customers receive higher payments for demand side response at the expense of smaller customers; however the real winners are particular shippers who are in business for short term gain or happen to serve particular customer groups.

It is also difficult to understand why these gas reserve contracts are linked solely to demand side flexibility especially as it appears that the modification proposal is little more than a paper 'title' transaction at the NBP. Storage flexibility, swing and increased interconnector flows all represent alternative forms of upward flexibility – why are these not part of gas reserve arrangements. To not include these is surely discriminatory.

It is important to remember of course that we have already have a reliable and effective route to market for all forms of flexibility. It is called the on the day commodity market. This direct simple to use mechanism, allows upward flexibility (including demand side) to be offered by shippers to the market at short-notice, at prices that reflect short-term supply-demand fundamentals. Balancing actions are even reflected in cash-out prices immediately. These are all features that one might theoretically want from a market mechanism. Why are we wasting time inventing yet another balancing tool for NG especially one which has less utility than the OCM.

- (e) *so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards (within the meaning of paragraph 4 of standard condition 32A (Security of Supply – Domestic Customers) of the standard conditions of Gas Suppliers' licences) are satisfied as respects the availability of gas to their domestic customers; and*

E.ON considers that this proposal dilutes shipper incentives to balance which may ultimately threaten domestic customer supply security standards. Since the introduction of the Network Code in 1996 there have been a number of key changes that have helped to enhance balancing incentives. These include Powergen modification 415 which removed the cash-out tolerance band, modification 435 which introduced the minimum $SMP_{buy} - SMP_{sell}$ spread and more recent changes UNC 13a which reaffirmed NG residual balancing role by limiting NG interruption to constraint management and finally UNC 44 (emergency cash-out plus emergency curtailment quantity adjustments) which re-emphasised the critical importance of shippers energy balancing role and in particular demand side response to avoid an emergency. The proposed modification runs contrary to the rationale unpinning all of these previous proposals.

In our view the current roles of shippers who are collectively responsible for energy balancing and NG as residual balancer are clear and well understood. Introduction of this modification will extend NG's role and it would become uncertain as to who is ultimately responsible for securing demand side response.

Many shippers such as E.ON are striving hard to offer a range of demand side products (and have been even more strongly incentivised to do so since the introduction of modification 0044). A 'one size fits all' approach determined by NG (we assume that NG would have to define the form of a gas reserve tender as the modification is largely silent on this) may condition the market into one form of demand side response contract rather than allowing the market (i.e. shippers) to develop a range of innovative options for energy buyers.

This modification is a

- (f) *so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code.*

The proposal is currently inadequately defined. In our view all key commercial rules affecting the relationships between shippers and transporters should be set out in the UNC. By failing to adequately define the detailed tender process, under what circumstances NG should exercise such contracts, how cash-out prices will be affected and from whom the costs should be recovered, these will either have to be clarified through subsequent modifications or defined in non-code documents. The former is inefficient and the latter extremely poor governance as this would limit the future ability of market participants to propose changes to commercial terms for gas reserve arrangements.

The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

In our view this proposal dilutes shipper's primary responsibility for energy balancing and as such it undermines shippers focus on demand side response. Even the consideration of this proposal is hindering demand side contract negotiations between shippers and customers, as customers await Ofgem's decision on this proposal.

The proposal appears to require NG to agree sizeable forward option contracts with shippers. In our view this could significantly distort the market and have serious FSA implications for NG as they move beyond their current residual balancing role. The degree of intervention required by NG (and hence the level of distortion in the market) is unclear – would NG contract for enough demand side response to assure an adequate response under average, 1 in 20 or 1 in 50 winter conditions? Do they necessarily have to contract for all demand side response? How for example would they deal with multiple parties at shared supply meter points?

Comparisons have been made between this modification proposal and reserve contracts in electricity. We consider that such comparisons are flawed as in electricity NG contracts directly with an end-user and can directly measure the actual demand side response. Such arrangements are necessary to maintain the 'quality' of electricity or give time for bid-offer acceptances (BOAs) to be effected. Operating margins in gas fulfils the equivalent later function in gas giving time for shippers to respond to OCM actions. The important thing to note here is that reserve arrangements in both gas and electricity are intended to provide tools for the residual balancer NG, to satisfy short duration, near term physical requirements. These are not major forward positions in the market.

Depending on how option prices and exercise prices impact cash-out prices (the proposal is unclear in this respect) will affect the speed and nature of the market response. In the gas market cash-out prices are determined on a 'real-time' basis and any rapid escalation of prices ahead of a possible gas emergency will be quickly reflected in cash-out prices. Ex post adjustments and over-complication will inevitably weaken the immediacy and relevance of the cash-out price signal.

Worse still, the fixed exercise fee may place, albeit temporarily, an 'artificial' ceiling on cash-out prices, thereby weaken the pricing signal (i.e. incentives to balance) in the critical phase ahead of a possible gas emergency.

As stated above hiving-off market rules in to non –code documents will inevitably lead to industry fragmentation. This may ultimately threaten security of supply and safety of the system.

The implications for Transporters and each Transporter of implementing the Modification Proposal, including

- a) implications for operation of the System:**
- b) development and capital cost and operating cost implications:**
- c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:**
- d) analysis of the consequences (if any) this proposal would have on price regulation:**

No view.

The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

No view.

The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

No view

The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk

This would represent yet another bureaucratic process for shippers to manage which will inevitably add to our costs. The smearing cost risk for some shippers is potentially huge. As a minimum the shippers in aggregate will have to cover option fees of a few tens of millions and face potential exercise fee costs of hundreds of millions. Please refer to cost scenarios calculated by NG to illustrate this point. For shippers with a large domestic portfolio the smearing cost risks are greatest. Other shippers may incur smearing costs but without any means of mitigating that cost (e.g. producer affiliate shippers who simply trade at the NBP).

The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

Certain large I&C customers could gain financially. The competitiveness of storage and offshore swing is reduced relative to demand side response given that the existing gas reserve proposal is limited to demand side flexibility only.

Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

We consider that this proposal would force NG to take forward positions in the market that extends their role beyond that of 'physical' residual balancing. As such certain FSA regulatory obligations may apply.

Analysis of any advantages or disadvantages of implementation of the Modification Proposal

We have identified the following advantages:

- It may facilitate higher 'demand side' payments to I&C customers with this ultimately paid for by all customers.

We have identified the following disadvantages:

- Extending NG role risks undermining the efficiency of the market. If NG were to take significant forward positions through gas reserve arrangements they would inevitably distort the market. This may have important FSA implications for NG.
- The proposal is likely to be prohibitively expensive. Defining how expensive depends on defining the gas reserve tender quantity (the proposal is silent on this).
- It has significant financial re-distributional effects which harm competition between shippers and between suppliers.
- The proposal is inadequately defined and as such provides a vehicle for NG to do what it wishes with regard to the gas reserve tender and associated terms and conditions. Inadequate governance surrounding this proposal means that shippers face the prospect of subsequent unilateral changes to these arrangements by NG and no formal opportunity to propose their own changes if such rules are 'hived-off' into non code documents.
- NG, DNOs and shippers will incur costs to manage complex processes.
- Demonstrating demand side response has taken place as a result of the exercise of gas reserve contracts is likely to be difficult (if not impossible). It would certainly be an unwelcome administrative burden for transporters and shippers under near emergency conditions.
- Questions as to whom and when should demand side response be triggered adds to uncertainty which may lead to a delay in responding. Shippers may delay providing demand side response until instructed to by NG under gas reserve contracts.
- Gas reserve contracts may not be honoured under extreme price conditions,
- Alternatively the exercise price may become an 'artificial' ceiling on prices during a critical period in the run up to an emergency. The time taken to for the market to break through this ceiling may delay more appropriate prices (i.e. that reflect short-term supply-demand fundamentals) being signalled to the market.

The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

Nothing in this proposal directly affects safety as the (storage) safety monitors continue to protect domestic customers and designated protected customers. T

The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

Programme for works required as a consequence of implementing the Modification Proposal

No view

Proposed implementation timetable (including timetable for any necessary information systems changes)

Implementation in good time for winter 06/07 is infeasible, given that the proposal represents a fundamental change in the roles of NG and shippers. New systems and procedures for tendering, calling, measuring and recording the level of

demand side response under these arrangements are required. System changes to cash-out prices and smearing are also required. All these would have to be tested ahead of the winter.

Implications of implementing this Modification Proposal upon existing Code Standards of Service

No view

Yours sincerely,

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