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Dear Julian,

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

National Grid NTS do not support the implementation of this Modification Proposal 0086.

Our comments are as follows:

Background of Community roles for the provision of security of supply and the avoidance of a Network Gas Supply Gas Deficit (Safety Monitor Breach) Emergency.

It is widely accepted that Users have the primary responsibility to balance their supply and demand portfolio on a daily basis. This role is captured in the shipper licence Condition 3. In support of this primary obligation National Grid NTS takes on the role of the Residual System Balancer. This role has been subject to progressive refinement since the introduction of competition most recently with the removal of the Top-Up Regime (Modification Proposal 0710) and the removal of the associated Supply and Demand Interruption trigger (Modification Proposal 0740).

In its decision letter for 0710 Ofgem noted that *“We consider that the arrangements in gas will be sufficient to allow customers to interrupt, if they choose to do so, in response to the price signals. We would note that severe conditions imply a long period of very cold weather, and thus – most likely – a long period of relatively high prices that would inform customers’ decisions with respect to demand side response. Ofgem also notes that arrangements for demand side response can often be put in place at relatively short notice. During a very severe winter, at the level of gas prices likely to prevail, large customers with firm gas supply arrangements would be free to enter into arrangements to sell some or all of their gas back to the market either on the gas day or ahead of the day.”*

In its decision letter on Modification Proposal 0740 Ofgem stated that it *“agrees with the majority of respondents and Transco NTS that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would be consistent with maintaining Transco NTS’s role as residual energy balancer and would provide greater clarity in regards to the roles and responsibilities of Transco NTS and the market.”* And that *“Under the current arrangements there may be confusion over the respective roles of shippers and Transco in balancing the market. The current rules provide Transco with*

the option to interrupt a potentially significant volume of demand under certain demand conditions. The existence of these contracts blurs the distinction between Transco's role and shippers' roles in balancing the system. Any confusion that may exist over the circumstances in which Transco may call interruption for demand/supply purposes may undermine the commercial incentives that shippers face to balance their inputs and offtakes". "Ofgem further considers that it is the primary role of the gas producers, storage operators, shippers and suppliers to ensure that customer demands are met and to secure supplies, not the role of Transco as SO."

Both of the above Modification Proposals were brought forward by National Grid following debate with the industry and demonstrate our commitment to the development of an open, liquid, efficient and economic gas regime supported by clear accountabilities, responsibilities and incentives. Whilst we can see that this GdF Proposal may appear to have merit, in that it may result in end consumers having more confidence that they will be rewarded for their ability to offer demand side turndown, there is no doubt that changing one party's role in the provision of a supply and demand balance in isolation will introduce asymmetry in the market, "*confusion over the respective roles of shippers and Transco in balancing the market*" referred to in the Ofgem decision letter on Modification Proposal 0740, may dilute the price signals, and would result in unnecessarily monopolistic interference in the commercial relationship between the shipper and its customer therefore introducing uneconomic and or inefficiently incurred costs.

Our involvement in the Ofgem chaired Gas Reserve Working Group meetings and with the Proposer demonstrates that we are committed to addressing the issue of supply security as the GB market moves towards a greater gas import dependency. With this in mind we consider that if securing supplies or compensatory payments to consumers above and beyond that already provided for through the Storage Safety Monitors is an objective that the industry feels is appropriate then the roles, responsibilities and incentives of all parties should be changed in unison in order to mitigate the risks identified above and provide a clear direction for the industry going forward.

As such we feel that any merit in the GdF Proposal is outweighed by the adverse impact, created by limiting the Proposal to the role of National Grid, on the clarity of all industry parties roles and efficient provision of market incentives for Users to complete their primary balancing role and security of supply.

Nature of the Proposal

National Grid NTS are concerned that, despite several attempts by the community during discussions in the UNC Transmission Workstream, at the Ofgem chaired Gas Reserve Working Group meetings and in one to one discussions with the Proposer, the Proposal still lacks clarity in a number of key areas and is therefore open to considerable interpretation. As a result we consider that this Proposal is at very high risk of being mis-interpreted by those responding to this consultation. We consider that the risk of such mis-interpretation is significantly higher than for Modification Proposal 0021 which was subsequently rejected by the Authority partly on the grounds of the risk of mis-interpretation of the term "Interruption". The complexity and far reaching nature of this Proposal and the extensive room for misinterpretation would, in our opinion, mean that it is unlikely that respondents to the consultation process have been able to properly and fully understand the intent of the Proposal. This situation would necessitate the same treatment of this Proposal as accorded to 0021 to allow for extensive further development and clarification.

The Proposal requires that any Availability Costs are fed through to the SMP_{buy} price. This concept is a departure from the current regime structure since SMP_{buy} is currently only used as a means to set a System Clearing price i.e. balancing incentives and is not currently a cost recovery mechanism. This departure from the current regime was pointed out to the Proposer on a number of occasions during the various meetings referred to above however the wording of the final Proposal is clear that availability costs should feed into SMP_{buy} prices and no other route to recover these specific costs has been included.

It is also unclear what the Proposer had in mind by requiring that these availability costs are targeted on the "polluter pays principle". Our interpretation of this is that the term "polluter" in this instance is directed towards User(s) that have a negative imbalance position following the 'after the day' allocation processes. This would seem to be potentially unfair because the proportion of the availability cost picked up by an individual User would depend not only on the User's own imbalance position at the end of the Gas Day rather than at the time that the action was taken but also the imbalance position of all other Users.

For example, in a scenario where National Grid contracts for a volume of gas sourced from demand response. The availability costs might be £1m which equates to approximately £5,500 per day for a 180 day winter period. This £5,500 is required to be recovered from the "short" User(s) by an adjustment to the SMP_{buy} price.

Say there were a number of Users with "short" positions at the end of the gas day, in order to target the costs at these Users via SMP_{buy} the SMP_{buy} price needs to be retrospectively adjusted. For example;

User A is 1000 therms short
 User B is 5000 therms short
 User C is 4000 therms short

Total of the short positions is 10,000 therms
 Cost to be recovered is £5,500
 SMP_{buy} adjustment required 55p/therm

In the same scenario if User A was the only short User, the adjustment to SMP_{buy} would be £5.50/therm.

Whilst the recovery of costs in the way required by the Proposal could be made to work by the retrospective price adjustments shown above, the consequences of amending individual User cashout prices in this way are potentially far reaching. Firstly any visibility of the User's applicable SMP_{buy} price, within the day, would be lost. Users would not therefore know their exposure to imbalance positions until sometime after the day in question. Secondly in the example used above, the daily cost of the availability charge is relatively modest. Depending upon the volume of gas from Demand Response that National Grid is required to secure, the daily cost could be significantly higher, e.g. the "Above the line analysis: Option 3" cost analysis carried out by National Grid NTS, at the request of the Gas Reserve Working Group and subsequent parameter definition by Ofgem, shows potential availability costs of £935million or approximately £5.2 million/day. Clearly focusing these type of costs on "short" Users alone would have a significant effect on User solvency.

Also, since the availability costs are incurred everyday (including days where the Total System is balanced or long on gas) it is entirely feasible that no User is actually "short" at the end of the day. The Proposal does not explain how availability costs should be recovered in this event i.e. where there is no identifiable polluter. Do the costs rollover to the next day or are these costs then smeared between the non polluters? In our view the Proposal can not be implemented until such time as this question is answered and fully consulted upon by the industry.

Another area where the Proposal lacks clarity is that Proposal does not clearly state what it is that National Grid would be buying in any such contracts. The question remains as to whether we would be buying an action from the User to turn down a specific supply point, or buying title to gas.

Extent to which implementation of the proposed modification would better facilitate the relevant objectives as stated in the Gas Transporter Licence Standard Special Condition A11.1

The Proposer has made a number of statements regarding how the Proposal will further the Relevant Objectives. National Grid NTS would like to make the following comments concerning these statements.

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

The Proposer has stated that "by ensuring that National Grid Gas NTS has an addition to the necessary but limited tools available at their disposal to facilitate its residual balancing role. Contracting for gas reserve in an economic manner in advance may protect the residual balancer from on-the-day exposure to very high prices on difficult days for the system and as such introduce additional efficiencies and reduce the overall costs of system actions. National Grid NTS will be incentivised to ensure efficient and economic procurement of the gas volumes to be utilised via this mechanism. This modification Proposal will provide for additional demand response to the market at the time when the Total System most requires it.

Additionally we consider that a direct route to market for Daily Metered customers, through their User, backed up by a clear availability incentive will bring more demand response to the market, enhancing security of supply."

If the tool is to be used solely in relation to National Grid's current Residual Balancer role then the objective function of this Proposal is no different to that currently provided for in National Grid's licence terms, incentive structure, and System Management Principle Statement other than introducing the obligation to run a demand side tender regardless of whether or not such tender process was deemed beneficial to the completion of this role. Subject to the points made earlier with regard to the Proposal lacking clarity about exactly what is being purchased, any responses to the tender would be assessed under the same criteria as is currently used in the role of the Residual Balancer. If this is the intent of the Proposal then it does little if anything to build upon the current arrangements since if we considered that running a tender of this nature would result in us completing the Residual Balancing role in a more efficient and economic way then, in response to our current licence conditions and the incentives placed upon us, we would undertake such actions now.

We have not taken such action since we believe that our current residual balancing actions are the most economic and efficient, are in line with our licence incentives and furthermore they also serve to fulfil another relevant objective of securing effective competition between shippers and suppliers by enabling the maximum opportunity for them to manage their own portfolios in order to collectively achieve their primary role of balancing supply and demand and thereby maintaining security of supply.

We do not consider forward contracting for a gas reserve in this manner to be economic and efficient since we would not have the necessary information to complete an efficient assessment of the required volume of contracts and we would be in the position of a monopoly purchaser for this service. It could therefore be expected that a premium, over and above the equivalent cost incurred by parties within a fully liquid and competitive market, would be likely to be incurred. A premium of ~10% was alluded to during discussions at recent Gas Reserve Working Group meetings and included in the "Above the line analysis: Option 3" paper. Indeed this premium has also been referred to recently in an article entitled "Italian Ministry to release new emergency measures for the next three winters" published in the ESGM (12.110) on 9th June. Gilberto Dialuce, the Gas Director of the Industry Ministry, noted that "tendering with industrial customers and generators for gas did not prove very efficient when it was administered last year by the regulator". He added that, industrial users asked for high prices and the scheme proved "very expensive".

With regard to the Proposer's statement that the Modification Proposal will provide for additional demand side reduction to be brought to the market. National Grid considers that there is nothing to suggest that this situation could not, or will not, be achieved by Users for themselves in a more economic and flexible fashion using current market and incentive mechanisms or indeed that any barriers exist to deter such arrangements. National Grid has consistently supported the development of market arrangements and incentives to encourage active management of supplies and demands by the parties who hold this primary obligation, and continues to consider that this approach is preferable to monopoly intervention as put forward by this Proposal.

We hold some concerns relating to the Proposer's statement that the demand side options contracted for by National Grid would be "in addition" to those already contracted for by Users. These concerns surround the fact that the Proposal does not provide any indication or suggestion as to how this position could be demonstrated or enforced. We consider that the above concerns may be addressed to a degree by an additional UNC Modification Proposal requiring Users to disclose where and what Storage, supply and demand side response contracts they have in place prior to publication of the tender. Such disclosure may facilitate the demonstration of this point and provide some comfort that, by contracting for demand side response, the Residual Balancer was not over-contracting or displacing existing User contracted

demand side response and as a result would assist in any demonstration that such contracting was beneficial to the economic and efficient operation of the system. Aggregate publication of the above User information may also serve to promote competition and provide signals for investment and could possibly assist in the identification of "the polluter" as required in the Proposal.

(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;

As detailed above, subject to the chosen interpretation of the objective function of entering such demand side contracts (and what is to be purchased by such contracts), it could be considered that this Proposal does not change, or therefore enhance, the efficient and economic operation of the system. Indeed it could be argued that the Proposal's only effect in this area is to introduce an obligation to complete a tender for demand side response. Should such tender only result in offers being submitted which are considered to be less efficient or economic than delaying residual balancing actions until the requirement for such action is more clear, then it could be argued that placing an obligation to run such a tender, rather than the current situation of having the option to run such a tender, could in itself be inefficient and uneconomic.

We also draw the SME's attention to the points made in the previous section in regard to efficient and economic operation of the system.

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

As detailed above, National Grid's SMPS currently does not preclude us from instigating tenders such as those described in this Proposal and therefore this Proposal does not further this objective. Indeed as detailed above, in obliging us to complete such a tender the Proposal may be detrimental to this objective.

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

The Proposer has stated in relation to: "the securing of effective competition between Users and suppliers" by introducing a wider range of contracts available to daily metered customers and reducing current barriers in the market to demand side participation.

National Grid does not consider that there are currently barriers to participation in the market by Daily Metered customers. Users and suppliers are, currently, entirely at liberty to develop these contracts and offer them to their customers without the need for intervention by the gas Transporter and therefore we do not consider that the barriers referred to above actually exist or if they do, no one has demonstrated the existence. Furthermore the multiple player market is far better placed to offer the varied and flexible contract terms, often required by consumers, than any monopoly buyer is likely to be.

Monopoly Transporter intervention, as described in this Proposal, would serve to restrict the market's access to this demand-side response as it would effectively be "reserved" for the Residual Balancer's use only. Such a situation is clearly comparable to the restriction of storage gas from the market under the old Top Up counter-nomination process. As described in Ofgem's decision letter in regard to Modification 0710 "**Removal of Top-up arrangements**"¹ such restriction of flexibility "*could result in significant increases in spot gas prices*" and "*forward prices*" and that "*These price increases could have a significant negative impact on customers. They could, in particular, impact on larger industrial and commercial customers whose prices are often indexed to movements in spot gas prices.*"

Furthermore since any gas reserve contracts envisaged by this Proposal are required to be undertaken via a User, associated with the end consumer, this Proposal does not address any perceived barriers, real or otherwise, to participation by the end consumer in the demand side market. The Proposal (and indeed the Gas Act) requires the contractual relationship to be between National Grid and a User. Users/Suppliers would then contract with consumers. National Grid is not sure what advantage would be gained by our involvement in this transaction that could not already be achieved.

- (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;**

The Proposer has stated: "*the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects to the availability of gas to their domestic customers*" by adding additional security of demand side response over and above storage safety monitors and reducing the likelihood of any emergency escalating to stage 3 firm load shedding.

We consider that implementation of this Proposal might have the unintended consequence of weakening incentives on Users in this respect. National Grid consider there is a real risk that this Proposal is seeking to extend the Residual Balancer role towards contracting for demand side response to manage the longer term "duration" balance of the system i.e. , as stated in the Proposal, the "*avoidance of a Gas Deficit Emergency*" Safety Monitor breach. We are concerned that such an extension could result in National Grid being drawn into an ever widening role in regard to the provision of security of supply. For example, as we secure contracts for a reduction in demand, Users might then adjust their supply contract positions by an equal, or greater, amount to reflect their perception of a reduced security risk as a result of the National Grid "insurance policy". This could then impact upon the volumes delivered at the 'beach' and incentives to provide storage capability or other forms of flexibility. In this way the role of Users in supply/demand balancing would be reduced and National Grid may be drawn into an increasing cycle of contracting for demand side reduction in order to affect a "duration" security of supply system balance.

¹ Ofgem decision letter relating to Modification Proposal 0710 – Removal of Top-up arrangements dated 18th October 2004

The Proposer's statements above seem to indicate that their Proposal will reduce the recourse to "firm load shedding"; however this is not the case. It is clear that going into any winter period the amount of available supply over that winter period is fixed. For this supply to be able to meet demand, demand must be managed to the point where it is equal to or less than potential supply. Whether such "firm load shedding" is the result of a stage three process or through pre-arranged demand-side contracts does not change the fundamental equation of the volume of demand-side management required.

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

It is National Grid's viewpoint that this Proposal is not required for the furtherance of Security of Supply to domestic end consumers, furthermore National Grid considers that this Proposal might have certain unintended adverse consequences for Security of Supply.

- National Grid is aware of anecdotal evidence suggesting that, uncertainty caused by the current ongoing debate around the issues raised in this Modification Proposal, has at least delayed and at worst may have prevented Users and end consumers, putting in place the commercial interruption contractual arrangements needed for winter 2006/07. We are therefore concerned that the existence of this Proposal, irrespective of whether it is implemented or not, has caused a significant degree of uncertainty throughout the industry that could have a detrimental impact on the Security of Supply position for winter 2006/07.
- We consider that implementation of this Proposal might have the unintended consequence of weakening incentives on Users for the provision of security of supply. We consider there is a real risk that this Proposal is seeking to extend our role towards contracting for demand side response to manage the longer term "duration" balance of the system i.e. the "avoidance of a Gas Deficit Emergency" Safety Monitor breach. We are concerned that such an extension could result in National Grid being drawn into an ever widening role in regard to the provision of security of supply. For example, as we secure contracts for a reduction in demand, Users might then adjust their supply contract positions by an equal, or greater, amount to reflect their perception of a reduced security risk as a result of the National Grid "insurance policy". This could then impact upon the volumes delivered at the 'beach' and incentives to provide storage capability. In this way the role of Users in supply/demand balancing would be reduced and National Grid may be drawn into an increasing cycle of contracting for demand side reduction in order to affect a "duration" security of supply system balance.

Introducing "obligations" or "expectations" on National Grid to contract for demand side management were it is clear from information supplied by the industry as a whole that some level of demand side response will be required if the coming winter period is severe may appear a logical safety net or community insurance policy for the industry. As such this should not be dismissed if all parties are aware of this "obligation", the extent and nature of the "obligation" is clearly defined and agreed by all parties and National Grid is suitably funded for completing this task. However, such a step is a significant departure from the previous drive towards a minimal Residual Balancer role

and reliance on market forces and commercial incentives to deliver security of supply.

Changing one industry party's role in isolation will not be sufficient as no one party has control over all the factors (beach supplies, storage booking and utilisation, demand management etc) which come together to maintain security of supply over a winter period. Therefore changing just one party's role risks introducing, asymmetry in the market, uncertainty and duplication of effort and therefore the introduction of uneconomic and or inefficiently incurred costs.

Our involvement in the Ofgem chaired Gas Reserve Working Group meetings and with the Proposer demonstrates that we are committed to addressing the issue of supply security as the GB market moves towards a greater gas import dependency. With this in mind we consider that if securing supplies or compensatory payments to consumers above and beyond that already provided for through the Storage Safety Monitors is an objective that the industry feels is appropriate then the roles and responsibilities of all parties should be changed in unison in order to mitigate the risks identified above and provide a clear direction for the industry going forward.

- There is potentially a further unintended consequence of this scheme. The Proposal does not make clear the details of the transaction between the User and National Grid (not least of which is whether or not title to gas is transferred). However, whilst not detailed in the text of the Proposal, at the Transmission Workstream on 1st June 2006, the Proposer stated that the intension of the Proposal is that the User would be required to deliver on any such contracts with National Grid regardless of whether or not they were still contracted with the end consumer. Such a statement would seem to dictate that such transactions would be non locational actions from the User to the Residual Balancer at the NBP only. It is therefore a little confusing why the Proposal then goes on to reference User Nominations at a System Exit Point as a means of calculating the volumes called under the contracts since if the User is no longer registered at an Exit Point then it does not have the ability to nominate at that Exit Point.

If the Proposal does intend that the contract should have a physical delivery element or link to an offtake's consumption then it would be necessary to consider the situation were the time delay between contract signing and delivery has resulted in the end consumer changing their User. It would also be necessary to reconsider the volume calculation for Day two and beyond under the contract for the same reasons as recently given by National Grid in our response in relation to Modification Proposal 0054a as the Proposal's current reliance on Nominations may be inappropriate for Day two.

The Proposer confirmed at the UNC Transmission Workstream meeting that transactions would result in the User's imbalance position being adjusted via an 'ECQ' type methodology. However this stated requirement has not been included in the text of the Proposal. If this is to be the intension of the Proposer then in this case the User would still be incentivised to deliver the originally intended supply quantity to the system. If the User's original intention had been to deliver this quantity of gas to the System from storage stocks then it is most likely that it will continue to do so to meet this trade obligation regardless as to whether the demand has turned down/off. Under this scenario there is a risk that the execution of the proposed demand side reduction contracts will not achieve the stated intension of "avoidance of a Gas Deficit Emergency".

- A further potential unintended consequence of this Proposal (if the title to gas trade is included) relates to the fate of the gas purchased by the Residual Balancer under the demand side contracts under a security of supply scenario. When the Residual Balancer purchases demand side reduction through a balancing action from a User the effect is to change that User's imbalance, by moving title to the gas to the "system", which the User will be incentivised to try and correct by delivering on the trade i.e. maintaining its intended supplies to the system whilst reducing its demand. If such contracts are used for the avoidance of a Gas Deficit (Safety Monitor Breach) Emergency, as indicated in the Proposal, there is a realistic scenario whereby execution of the demand side contracts transfer title to gas sufficiently to result in system linepack increasing to a level where a Residual Balancer sell action is required to maintain the safe operation of the Total System. The impact of this could be to reduce system prices to a level where other, User interrupted, offtakes are encouraged to increase their demand. The net result of executing demand side contracts in the manner suggested in the Proposal could therefore be a seesawing effect on the system linepack, increased Residual Balancing actions and increased price volatility rather than an avoidance of a Gas Deficit Emergency. As such the Proposal does not achieve its stated purpose

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

National Grid NTS has undertaken its assessment of the implications of Modification Proposal 0086 on the Transmission System Management Principles Statement (SMPS) and the Procurement Guidelines (PGs). The existing SMPS and the PGs provide National Grid with the opportunity to utilise various tools to manage (i.e. balance) the Total System in an economic and efficient manner, including (but not limited to) the use of tenders, forwards and options. National Grid has identified several changes to the SMPS that would be required should the Authority direct the implementation of 0086 and are based on an understanding of the Proposal. These changes have been communicated separately to the community.

a) implications for operation of the System:

The Proposal is insufficiently clear in a number of areas including the objective function of any proposed tender process to allow an accurate assessment of impacts in this area. One view of the Proposal would suggest that the role and Objectives of the Residual Balancer are not affected by this Proposal. In such case, we believe the Proposal adds nothing to the operation of the System that is not currently available.

Another view is that the Proposal seeks the "avoidance of a Gas Deficit Emergency". This could mean the avoidance of a Safety Monitor Breach. Such an interpretation would have profound and far reaching implications for the operation of System and the role of the Residual Balancer.

Subject to the interpretation of the Proposal as being that these contracts should be used on days as and when required by the Residual Balancer i.e. not being restricted to those days where a GBA is in force, and on the understanding that there could be

consequent effects on the cashout and price determination for these days of using these contracts, then the following changes may be applicable;

SMPS - Part C, Section 3.1 National Requirement

1. Clarification that the primary system management tools are the OCM and where appropriate, OTC trades.
2. Remove the dependency for OTC trades to be taken only in the event of a GBA, and, as an Eligible Balancing Action – thus extending the potential for the Residual Balancer to complete OTC trading to all time periods where it considered such trades to be efficient and economic.

b) development and capital cost and operating cost implications:

Again as detailed in (a) above the Proposal is insufficiently clear in a number of areas including the objective function of any proposed tender process and contract execution to allow an accurate assessment of impacts in this area.

c) extent to which it is appropriate to recover the costs, and Proposal for the most appropriate way to recover the costs:

The responsibility for ensuring that the goods sold to a consumer are actually delivered to the consumer rests, in the gas market as in any other market, with the party who sold those goods to the consumer. National Grid therefore consider that it is appropriate that any costs associated with National Grid taking on the primary role of ensuring continued supply to these consumers should be borne by, and where possible targeted at, those who have defaulted on their contractual obligations.

d) analysis of the consequences (if any) this Proposal would have on price regulation:

If the objective function is interpreted to expand National Grid's role, then there would be a need to develop appropriate System Operator funding arrangements for the extended role.

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

Again as detailed above the Proposal is insufficiently clear in a number of areas including the objective function of any proposed tender process and contract execution to allow an accurate assessment of impacts in this area. Currently the role of the Residual Balancer is predominantly completed via the On-the-day Commodity Market (OCM). Every transaction completed in this market has the Market Operator as a third party. As such the contractual risk of delivery on such trades is between National Grid and the Market Operator only. OTC trading is currently restricted to post GBA events. This Proposal seeks to extend the Residual Balancer's access to

OTC trading to cover all periods. This may result in an increase in the level of contractual risk for National Grid.

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

The Proposer has stated, in some areas of the Proposal text, that; *"It is intended that details of tenders and call off of services will be communicated to the market in a timely manner through existing systems"*. National Grid would comment that given the lack of clarity in the Proposal the impact on existing systems of any incremental workload cannot yet be assessed because the number of contracting parties involved is unknown as are the details of the contract call-off process and the volumes and triggers. Indeed, from the content of the Proposal, National Grid is unable to accurately assess whether or not any additional systems will be needed. Should either new systems need to be developed or existing systems require upgrades the development timescales needed to achieve these changes may be unachievable in the context of the proposed implementation timescales.

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

The costs of the Residual Balancer activities are funded by the Balancing Neutrality processes. As a result Users are exposed to the same changes in contractual risk as the Residual Balancer. Therefore our comments in relation to Transporter contractual risk also apply to this section.

The Proposal includes *"tender process guidelines"* which include establishing a tender methodology which would establish the *"desired volumes of load curtailment"* in a way that is similar to the process in place for Operating Margins gas. This methodology would be established by National Grid NTS. Operating Margins is almost exclusively used to support the operation of the system, i.e. plant outage, whereas the demand side contracts envisaged in this Proposal are for the Residual Balancer role and or the avoidance of a Gas Deficit Emergency. Unlike Operating Margins Gas the Utilisation Costs incurred in response to this methodology will be smeared to Users via Balancing Neutrality. We therefore do not consider that it is appropriate that we should have the responsibility for establishing this methodology. In our opinion it would be better for the Users who directly benefit, and incur the costs resulting, from this methodology to have the responsibility to establish it.

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

Again as detailed in (a) above the Proposal is insufficiently clear in a number of areas including the objective function of any proposed tender process and contract execution to allow an accurate assessment of impacts in this area. However, monopoly Transporter intervention, as described in this Proposal, would serve to restrict the market's access to this demand-side

response as this would be presumably “reserved” for National Grid use only. Such a situation is clearly comparable to the restriction of storage gas from the market under the old Top Up counter-nomination process. As described in Ofgem’s decision letter in regard to Modification 0710 “Removal of Top-up arrangements²” such restriction of market access to available flexibility “*could result in significant increases in spot gas prices*” and “*forward prices*” and that “*These price increases could have a significant negative impact on customers. They could, in particular, impact on larger industrial and commercial customers whose prices are often indexed to movements in spot gas prices*”

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 will confuse the roles, responsibilities and obligations with regard to security of supply between Users and Transporters. This will be a retrograde step as these issues have only relatively recently been clarified as a result of the removal of Top Up and the associated ability of the residual balancer to interrupt consumers for Supply/Demand purposes.

We are concerned that implementation of this Proposal would, given one interpretation of the Proposal, result in a series of complex contractual relationships between National Grid and Users being put in place. It is also envisaged that each contract put in place between National Grid and a User would be subsequently backed up by a corresponding contract between the User, their supplier and their end consumer. We are not convinced that this new role for National Grid would be more efficient and economic than current arrangements. Nor would such contracting be able to guarantee that any payments made by National Grid to the User under such contracts would subsequently be delivered to the end consumer. In this respect the Proposal does not change the contractual relationship between shippers, suppliers and end consumer.

National Grid also believe that consideration will need to be given to the transfer of customers between Users and how any contracted demand side response would be dealt with in these circumstances.

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

The Proposal lists a number of advantages brought into play by National Grid contracting for demand side response. However we consider that there is nothing to suggest that the majority of the advantages listed by the Proposer, could not already be realised by Users for themselves in a more efficient, economic and flexible fashion using current market and incentive mechanisms. We have consistently argued that industry focus should be on developing this User/supplier to customer relationship as a means of securing the most efficient and economic operation of the regime.

² Ofgem decision letter relating to Modification Proposal 0710 – Removal of Top-up arrangements dated 18th October 2004

⁴ Ofgem decision letter relating to Modification Proposal 0710 – Removal of Top-up arrangements dated 18th October 2004

We have identified the following disadvantages:

- Monopoly Transporter intervention, as described in this Proposal, would serve to restrict the market's access to this demand-side response as it would be "reserved" for National Grid use only. Such a situation is clearly comparable to the restriction of storage gas from the market under the old Top Up counter-nomination process. As described in Ofgem's decision letter in regard to Modification 0710 "**Removal of Top-up arrangements⁴**" such restriction of flexibility "*could result in significant increases in spot gas prices*" and "*forward prices*" and that "*These price increases could have a significant negative impact on customers. They could, in particular, impact on larger industrial and commercial customers whose prices are often indexed to movements in spot gas prices*".
- A single Monopoly purchaser of such demand-side contracts rather than market procurement will lead to a premium being paid.
- Any assessment of the requirement for such Residual Balancing actions many months before information is available on the Users' intended imbalance position would be ill-informed, subject to extensive uncertainty and in our opinion likely to be considered inefficient and uneconomic.
- The Proposal is subject to considerable uncertainty and interpretation and as a result it is unlikely that respondents to this consultation process have properly and fully understood the intent of the Proposal.

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

None.

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

None

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

Should this Proposal be implemented, implementation actions would depend to a large degree on the interpretation of the Proposal. One interpretation would result in the publication of a Tender and feeding any actions taken into Cashout and Balancing Neutrality. Under another interpretation, based upon an understanding of the Objective Function of the scheme being to assist in the avoidance of a Gas Deficit Emergency (which includes a Safety Monitor breach), the programme of works to implement the Proposal would be extensive. It would potentially include, but not be limited to the following.

- ◆ **GT Licence**
 - ◆ Definition of the Objective Function of the new role.

- ◆ Development of SO funding arrangements for the completion of the new role.
- ◆ Possible changes or additions to the SO incentive structures to recognise the new role.
 - ◆ The GDF Proposal calls for new SO incentives to procure the gas reserve economically & efficiently.
 - ◆ The current SO pricing incentive may need to be adjusted to encompass prices paid in the demand management contracts as well as those paid 'On the Day'.
- ◆ **UNC Changes**
 - ◆ Text contained within the Proposal document calls for a gas reserve tender methodology statement to be developed. Initially this would sit outside of the UNC but would ultimately be placed within the UNC governance framework.
 - ◆ Current rules stipulate that multi-day trading is limited to a seven day period; this period may need to be extended to allow sufficient flexibility in contracting for demand side services to cover "duration" events or the wishes of some tendering parties.
 - ◆ Current rules stipulate that a residual balancing action can only be taken where there is an identified 'Operational Balancing Requirement' applicable to a particular Gas Day. UNC will need to be changed to allow deployment of the gas reserve tool on days where there might not be Balancing Requirements specific to those Gas Days i.e. as discussed in the Network Code Transmission Workstream during the development of Modification 0710 it is reasonably conceivable that a Gas Deficit (Safety Monitor Breach) Emergency could be triggered without there being a Operational Balancing Requirement. Since this Proposal seeks for these contracts to assist in the avoidance of such Emergencies then the rules restriction above would need to be removed to allow the Residual Balancer to take an action without an operational requirement being identified.
 - ◆ Changes to cashout determination would be required to enable scheme prices and costs to be fed into the process. It should be noted however that the Proposal is somewhat confusing in this area as it refers to "costs" being recovered through cashout processes which would require a reconfiguration of the cashout process and function.
 - ◆ Additional or extended payment and credit terms will need to be established. Currently the Residual Balancer trades pre-dominantly with one party, the Market Operator, and therefore, to the most extent, have a single credit relationship through the Energy Balancing Credit Committee (EBCC). In future the Residual Balancer may be require to expand its contracting with multiple parties and thus will require extended credit arrangements with each of them agreed by the EBCC.
 - ◆ In order to efficiently and economically assess any demand side tender responses there may be a requirement for new information flows to be instituted e.g. information on the terms and conditions of the existing supply, storage and interruption contracts held by User prior to the tender process.

◆ **SMPS/PG**

- ◆ As detailed above some amendments to these documents may be required. Again this is subject to the interpretation of the objective function of the Proposal.

Irrespective of the Objective Function of the scheme the process to run the tender and the contracts associated with this activity will require development with input from Users.

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

Due to the uncertainty and lack of clarity in the Proposal it is not possible for us to comment on this area at this time.

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

Further Comments

National Grid would like to make the following additional comments.

- The Proposer has made the following statement under the heading 'Justification for National Grid Involvement'. *"National Grid NTS has statutory responsibilities to operate the Transmission System efficiently and economically. The proposed Gas Reserve Arrangement is intended to provide it with additional mechanisms for discharging the responsibility and to forestall a possible gas emergency, especially in circumstances where operational problems arise from issues with the system balance"*.

National Grid would point out that under the current arrangements it considers that it has the necessary tools to deal with operational problems and the operational balancing of the system e.g. access to the On the Day Commodity Market and to the Operating Margins gas reserve. However in this statement the Proposer appears to be confusing a concern about a gas Safety Monitor Breach and subsequent declaration, by the National Emergency Co-ordinator (NEC), of a Network Gas Supply (Gas Deficit) Emergency with an operational problem. National Grid would like to note that a storage Safety Monitor Breach is not necessarily related to a system operational problem but rather to the availability of energy. That is to say the system is operating normally but Users, as a community responsible for the primary balance of supply and demand, have been unable to supply sufficient gas to meet the demands they have contracted with. An example of this is where a storage Safety Monitor has or is about to be breached but the system is balanced and operating normally.

Furthermore we would note that we do not have the responsibility nor the tools available to us to totally prevent the occurrence of a Potential Gas Deficit (Safety Monitor Breach) Emergency following the introduction of UNC Modification 0710: Top Up Removal and UNC Modification 0740a: Amendment to Transco's Rights to Interrupt for Supply/Demand Purposes. These Modifications successfully clarified the roles and responsibilities of industry parties in relation to the provision of security of supply,

responsibilities of Users in their primary balancing role and those of National Grid in completing the Residual Balancer role.

However, we would note that we do have the necessary tools to manage all variants of a National Gas Supply Emergencies. In relation to a Network Gas Supply Gas Deficit (Safety Monitor Breach) Emergency these existing tools allow for an amount of time deemed necessary to allow for the market to respond. If the Proposer is concerned that the market may not respond or will respond but too slowly, then perhaps the incentives on the market to respond to 'Difficult Days' is not sufficient. If this is the case perhaps it would be better to concentrate on strengthening the current incentive for the market to respond rather than trying to supplement the market with monopolistic intervention.

- During discussions at the UNC Transmission Workstream on 1st June, and at other earlier UNC and Ofgem meetings, a significant element of the discussion focussed on trying to establish and clarify the 'Objective Function' of the proposed gas reserve tender and any subsequent contracting. Although this issue was not resolved at these meetings, and has yet to be resolved, the Proposer has commented that it saw the proposed gas reserve as being analogous to the Standing Reserve facility in the electricity regime. National Grid has reviewed the features of the electricity regime Standing Reserve and has concluded that the correct comparable analogy for the gas regime is with the existing Operating Margins facility. In doing so it is clear to us that the gas and electricity reserves currently procured are already significantly aligned, with differences arising solely due to the way the relevant markets operate (gate closure before the balancing period as apposed to gate closure towards the very end of the balancing period) and the nature of the energy product. This viewpoint is based on the information contained in the table below.

	Gas: Operating Margins Reserve	Electricity: Standing Reserve
Demand Forecast Error	Yes	Yes
Supply Failure	Yes (offshore)	Yes (generators)
Plant Failure (system constraint)	Yes	N/A
Orderly Rundown	Yes	N/A (no safety issue)
Plant Shortfall (after gate closure)	N/A (market able and incentivised to respond – no gate closure)	Yes (SO is the sole system balancer after gate closure)
Timescale for Addressing Problem	Short term; gives time for the market to respond circa 4 hours	Short term; gives time for the market to respond circa 4 hours

National Grid has recently completed a “request for proposals” aimed at looking at the opportunities available to expand the diversity in regard to the provision of Operating Margins gas this potentially includes the provision of this service from demand side participants.

Yours faithfully

Ritchard Hewitt
National Grid NTS