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Dear Julian,

UNC Modification Proposal 0086: 'Introduction of Gas Demand Management Reserve Arrangements'

Thank you for your invitation seeking representations with respect to the above Modification Proposal.

National Grid Gas plc (UK Distribution), ("Distribution"), is firmly of the opinion that this modification should not be implemented.

The proposal states that its implementation would establish a contractual framework that would encourage larger volumes of gas to be made available on the OCM by way of demand side sells. At the highest level we agree with this objective and that implementation could encourage greater volumes to be made available. However, we do not believe that implementation would achieve this objective in either an economic or efficient manner.

Making demand–side gas available is a shipper responsibility and there is nothing to prevent the shipper from putting these arrangements in place now. As we see it the main change to the UNC that would result from implementation would be requirement for National Grid NTS ("NTS") to pre-contract and pre-pay for demand side availability by way of bilateral arrangements set up between NTS and shippers. Such demand side response would have to be delivered through demonstrable supply point interruption whereas now demand side response, in the same way as supply side response, is a matter for the shipper's balance.

Distribution have two principle concerns: first, implementation would blur the role of the shipper as primary balancer and the SO as residual balancer, leading to inefficiencies; and secondly, the funding of these arrangements and the proposed smearing mechanism leads to cross–subsidies, (that have yet to be quantified), and an inappropriate distribution of costs.

Blurred Responsibility and Action & Reaction
Our first concern is that the proposal advocates the SO taking demand-side balancing actions at times when shippers should still be active in the market and trying to meet their individual balancing positions. A price spike could result in gas being called off at the same time as the shipper is trying to source gas to meet its demand. Having two parties, independently exerting control of a shipper's balance position would not result in the most economic or efficient operation of the market. We believe it is not appropriate for the SO to take demand-side actions simply because a pre-described price has been met. SO action at this stage could mean loads being "called-off", (i.e. interrupted), when in aggregate there could be sufficient gas to meet demand.

Funding and Cross-subsidies
Our second concern is that we believe that the implementation of this proposal could give rise to cross subsidies between market-sectors as the cost of funding the availability fees would be smeared across all gas customers. This would result in a considerable element being picked up by domestic customers. Many of the supply points that would be targeted as candidates for this arrangement already receive considerable transportation charge benefits as they are classed as interruptible, (and consequently may be interrupted by the transporter for capacity management purposes), by the transporter.

Where interruption convey balancing benefits, any further price inducements offered to the gas customer to interrupt should be fully funded by the shipper as it is the contract between the gas customer and the supplier that should define the supply terms and crystallize supply costs and risk. If the shipper requires additional interruption to balance then that should be established in the supply arrangements and the industry should not be looking to an availability scheme centrally administered by the SO and funded by smearing costs across all gas customers. NTS should not carry the responsibility for supply / demand interruption happens simply because suppliers are unable to strike the necessary deals.

In addition to our main concerns, should the proposal be implemented we believe that are some significant practical implementation issues that would first need to be addressed, including:

Operational Detail and Compliance
This proposal requires the SO to pre-contract for interruption, which could be called using OCM price triggers. Presumably, where the SO takes an eligible demand side action, the instruction would be first conveyed to the shipper and then subsequently an instruction to interrupt (at [x] hour's notice) would be passed to the gas customer. A successful instruction would result in that shipper's demand being reduced as a result of the nominated supply point reducing its offtake; the shipper would not be able to maintain its balance simply by increasing its supply side deliveries. Partial and within day interruption has always been difficult to monitor, although no doubt this could be resolved with the introduction of real time metering arrangement by the shipper. We understand that the shipper would validate compliance and confirm the volume delivered through the bilateral agreement.

Governance of the Bilateral Agreement
We do not understand why it is proposed that the Demand Side Response ("DSR") contracts are bilateral agreements and not industry-standard terms and conditions. These contracts are akin to the NExA arrangements and, on that basis, the DSR agreement would be ancillary transportation terms. Therefore, if the proposal is implemented, the framework agreement should be agreed through the existing code governance arrangements, with only the numeric variables agreed bilaterally. A common basic, highly visible, agreement is the only way that this scheme should come to fruition, as this is the only way bids could be ranked against each other, like-for-like. For instance, how would the SO rank bids where the default terms, or the pre-paid availability fee, differed across the bilaterals. Where the terms of the bilaterals differed, the value of the bids associated with them would also differ. Direct simple price comparison would not be possible, introducing market inefficiencies as markets work best where traded commodity is homogeneous.

Analogy with Electricity
During discussions it was suggested by some parties that a similar arrangement to that detailed in this proposal operates well in the electricity market. While we acknowledge that reserve arrangement works in electricity, we do not believe that this analogy inappropriate for a number of reasons.

When operating an electricity system, a level of reserve needs to be held at all times. The last element of this reserve will only be required on very rare occasions and hence it is economic to hold this plant on reserve using low availability payments but high utilization payment. The SO therefore optimizes its costs by contracting for standing reserve and reducing the level of reserve held on synchronized plant. This is quite different from the Gaz de France ("GdF") proposal for the following reasons:

- Standing reserve is generally utilized after gate closure: suppliers / generators are committed to their Physical Notifications and responsibility for balancing sits firmly with the SO;

- The regime of submitting Physical Notifications half-hourly up to gate closure ensures that the SO is aware of balancing actions being taken pre-gate closure by suppliers / generators;

- If standing reserve were not to be purchased, the SO would need to ensure that additional part loaded plant were available on the system. Standing reserve is only purchased to the extent that it serves to lower the cost of balancing the system.

Furthermore, the GdF proposal would have the effect of reducing imbalance prices in the run up to an emergency. By reducing the financial penalties for being short at a time gas scarcity, this will increase the likelihood of demand exceeding supply and make a gas emergency more likely.

Industry Support
From the industry discussion to date, we do not detect substantive support across the industry for implementation. This type of arrangement would require the full and willing participation otherwise any agreement struck would not be a market solution, rather the specific cost-avoidance economics of shipper(s) in favour of these agreements.

Our View
This proposal is different to many proposals in at least one significant way. Basically, this proposal only puts a broad, "open-ended" obligation on NTS to set up the DSR agreements but is relatively silent on much of the detail that would be included in these agreements and how they would operate in practice. For this reason we have also included some "conditional" comments which we believe should be considered at this stage to assist with the direction process. We appreciate this is not normal but, the "next-steps" issues should be considered now: how the DSR agreements work in practice is as important as their appropriateness in theory.

We do not believe that this proposal should be implemented. If the winter is long and cold and gas is in short supply, some shippers will, undoubtedly, find themselves short of gas. It is the role of the shipper to mitigate those risks. The risk mitigation should not be to rely on NTS to interrupt shipper demand, in a pre-determined price order.

Would it be NTS's role to bring to demand back on stream when the price dropped below the trigger price and how would such a transient demand interruption be quantified during the intervening period?

It is proposed that this would be a voluntary scheme so the objective cannot be to enhance national security. We believe the motive is more about reducing the cost of balancing at peak; we are firmly of the opinion shippers requiring demand side response should procure, and bear the costs of procurement, without relying on **all** gas customers to underwrite their balancing costs. The calling-off of demand should be in the realm of the shipper, implementation of what would be complex and game-able (in terms of how do you quantify how much gas has been delivered if the only way of quantifying it is be estimating how much would have been taken if the interruption hadn't occurred), arrangements would only add costs and uncertainty to the SO role.

Should the Authority be considering implementation, we trust that it will give due consideration to ensuring that the availability fees and administration costs incurred by the many are not excessive when compared with the benefits accrued by the few and that any cross-subsidy is not undue.

Also***, should*** the proposal be approved, at the very least, the arrangements should be standard code terms which would improve transparency and aid comparison of the resulting demand side bids and would give confidence to gas customers that approved standard arrangements were in existence.

We believe that arrangement advocated in the proposal is available to shippers now; all the proposal seeks to achieve is to revise the means of funding, and in the process blurring the line between the SO's and a shipper's responsibilities. We believe that payments made to effect balancing actions should be resolved between the shipper and its gas customers as it is between those parties where the benefits lie. An open-ended cross-subsidy should not be put in place and the SO should not be curtailing demand on a price basis; the shipper should be balancing using its own criteria in a manner that meets its business objectives.

Relevant Objectives
All aspects considered, we believe that implementation would not be consistent with National Grid's licence obligation to operate the combined pipe-line system in a coordinated, efficient and economic manner.

Accordingly, Distribution disagrees with the proposer's view that implementation would be consistent with requirements of Standard Special Condition A11.1(a) of their gas transporter's licence.

Yours sincerely,

Declan McLaughlin.