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## Urgent Modification Proposal 0086: Introduction of Gas Demand Reserve Arrangements

Dear Julian

Thank you for inviting us to comment on this urgent modification proposal. Like the proposer, we too have actively participated in Ofgem's Demand Side Working Group and the Transmission Workstream where arguments for and against an "above the line" gas demand reserve product have been widely debated.

RWE npower strongly opposes implementation of this urgent modification proposal 0086 and does not believe it is critical to assist security of supply this winter as claimed.

Our comments are as follows:

### General Objections

As an overriding principle, we believe that shippers should meet their customer's requirements and that the System Operator's (SO) involvement should be the minimum necessary to maintain the safety and operational integrity of the NTS. Implementation of Uniform Network Code modification proposal 013a "Amendment to Transco's rights to interrupt for supply/demand purposes" clarified the balancing responsibilities between National Grid Gas NTS and shippers. It confirmed that it is the primary role of the shippers and suppliers to ensure that customer demands are met and to secure sufficient supplies, not the role of National Grid Gas as SO. Clearly, we would strongly endorse this position and believe that implementation of modification proposal 0086 would undermine the clear demarcation set out in 013a and consequently dilute the commercial incentives that shippers face to balance their inputs and offtakes.

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It is this clarity of roles and responsibilities that creates the incentives on market participants to balance. Shippers are currently exposed to SMP buy prices, and the market is developing such that large daily metered end-user exposure to volatile short-term gas prices is generally increasing, both of which therefore face strong incentives. Shippers require access to flexibility to manage their position and demand-side contracts represent one possible source of this flexibility. We believe that it is consistent with the division of roles and responsibilities that shippers rather than National Grid Gas NTS are able to work directly with consumers to develop demand flexibility. Furthermore, if National Grid Gas NTS does gain access to this source of flexibility, it may weaken incentives on shippers to enter into demand-side contracts and may increase the costs faced by shippers in competing with National Grid Gas NTS for the same volume of demand-side response. Ultimately, we see costs to consumers rising as a consequence.

A key element of this modification proposal is the central role that National Grid Gas NTS has in contracting, procuring and deploying gas reserve. The proposer argues that National Grid Gas NTS involvement adds credibility. However, the addition of a strategic procurer of reserve undermines the efforts of suppliers, and causes inefficient and inconsistent price signals. The ensuing increased costs ultimately feed back to consumers.. This is a natural tendency when there is a monopsony buyer and has been observed in other markets. There is also a real danger that gas reserves procured by National Grid Gas NTS will displace the demand-side response that can be offered by shippers via the OCM. This will force those affected shippers to purchase alternative sources of flexibility, potentially at higher cost.

As drafted, the proposal sets out that gas procured under the gas safety reserve arrangements will provide National Grid Gas NTS “an addition to the necessary but limited tools available at their disposal to facilitate its residual balancing role”. In this regard, National Grid Gas NTS presumably believes that the available balancing tools are fit for purpose, a view with which we would concur. It is not clear what this modification proposal adds, as National Grid Gas NTS, in discharging its residual balancing role, could currently enter into these contracts without the need for a change to the UNC. They already hold forward tenders in other markets, such as for managing entry capacity buy-backs and presumably would enter into gas reserve contracts if they were more efficient than alternatives. If the intention of the modification proposal is to extend the National Grid Gas NTS balancing role, possibly to include explicit additional objectives than we question whether it would be more appropriate to seek to achieve this through a Licence rather than UNC route.

In its decision letter for Uniform Network Code modification proposal 013a "Amendment to Transco's rights to interrupt for supply/demand purposes" Ofgem noted that “As a general principle, Ofgem considers that it is a matter for Transco, as SO, to determine the appropriate structure for its contracts for both system and energy balancing, consistent with its obligations to operate the system in an economic, efficient and co-ordinated manner”. In our view, this principle is equally valid now and for the reasons outlined above, we believe that any extension of National Grid Gas NTS’ role would undermine the efficient operation of the market.

## **Electricity Comparison**

There have been comments made that the Standing Reserve Market in electricity is justification for introducing an analogous gas reserve market. We believe that this a spurious comparison due to fundamental structural differences between the two markets and the different natures of the large producers and consumers. Standing reserve is a form of flexible capacity that is made available to be called (despatched) exclusively by the electricity SO within gate closure timescales (i.e. 1 hour before the “real time” settlement period) to ensure that there is a physical balance of supply and demand in real time. The absence of a gate closure in gas means that gas market participants can

respond to individual energy imbalances during the gas day with any residual shortfall (or surplus) resolved by the SO using a variety of system management tools. The reserve capacity required by the electricity SO is defined in relation to physical system security standards (e.g. largest loss of generation infeed). This enables the system operator to determine a required level of “reserve” for each settlement period and a similarly transparent methodology is not so obvious in gas. The gas system operator mainly uses storage, linepack and existing interruptible contracts to provide similar contingency reserve. Finally, standing reserve is also needed to meet system requirements such as changes in electricity frequency as defined in the security standards and there is no equivalent requirement in the gas market.

## **Specific Comments**

The proposal describes high-level principles of how the arrangements may be implemented, but there remain a number of areas that require further development. This is recognised in the drafting and it is envisaged that development will be progressed in parallel with the modification process. However, without a full understanding of how gas reserve will be procured and deployed it is not possible to undertake an informed assessment of the proposal’s impact.

A gas reserve tender methodology statement is envisaged at some stage, but definition of the required volume of load curtailment and what is an economic and efficient cost is critical for shippers. As the intent is to recover the procurement and deployment costs through the energy balancing mechanism these will be paid by shippers and ultimately their customers.

Urgent Modification Proposal 0086 requires contracts to be based upon an availability/utilisation payment structure. We believe that these contractual arrangements could be offered by shippers if valued by customers. Npower has discussed these options with customers at Ofgem’s series of Options for Energy Buyers seminars.

As described, contracted gas reserve will be deployed in price order and may set the SMP buy price on a day. In essence, this just replicates the arrangements that are currently in place, and supports our argument that the gas could be offered into the OCM by a shipper. All this modification proposal appears to add is the introduction of uplift to the SMP buy price to recover availability payments.

The proposal also introduces complex contractual arrangements between National Grid Gas NTS, shippers and end-users. It is unclear where the contractual obligation to ensure physical delivery of the contracted volumes actually sits as National Grid Gas NTS will not have a direct contractual relationship with the customer. The position is even less clear where a customer changes shipper midway through its gas reserve contract and whether the obligation moves with the customer or remains with the original shipper. It is envisaged that the gas reserve volumes could be contracted to both the shipper and National Grid Gas NTS. In such circumstances, customers may be reluctant to offer demand response to their shipper in case National Grid Gas NTS calls it. This may exacerbate the position and, if it does not bring forward the gas emergency it may lead to high prices. Far from removing barriers to entry for I&C consumers providing a route to market, we believe there is a real danger that this proposal will confuse and complicate existing market participant arrangements that have developed over time and are well understood.

We are also confused as to how the demand volume reductions are expected to be calculated as the proposal seems to imply this is determined based on a site’s nomination on the day. This suggests that National Grid Gas NTS may not know how much of any reserve they have contracted for will actually be available to them until the day it is needed, and creates potential gaming opportunities for end users.

## **Impact on cash-out**

We do not agree with the proposal that availability payments be included in the cost calculation for SMP buy price on a flat daily basis. The details of how this could work in practice are far from clear and it would surely not be possible to set the uplift ex ante. This effect, together with any delay or lack of transparency in setting SMP buy in real-time may distort market reactions to price. Cash-out prices should provide appropriate commercial incentives for market participants to balance their own positions and reflect costs incurred by the SO as residual balancer when undertaking balancing actions. It is not appropriate for SMP buy price to be used to recover costs in this way as it creates a distortion. There is a marginally stronger case to recover the costs through neutrality as arguably gas reserves provide collective insurance, albeit at the expense of introducing a moral hazard problem by weakening individual shipper incentives and thereby raising the likely total costs of system balancing. The polluter pays principle is maintained as the utilisation costs may set SMP buy on the day. Our preference would be to not interfere with the derivation of cash-out prices at all.

The modification proposal suggests that as a general principle those awarded gas reserve contracts should be instructed to deliver agreed demand reduction volumes when it becomes economically efficient for National Grid Gas NTS to do so. This implies that demand reduction should be called at times when the cost of exercise is less than OCM market offers or prices on the day, which may not correspond to the times when the system is most under stress. However, one of the reasons cited as to why end users have become increasingly reluctant to enter into shipper interruption contracts is because of the concern that shippers will seek to extract the full commercial benefit arising from them. The same issue would seem to arise if National Grid Gas NTS access gas reserve contracts in an economically efficient manner.

## **Conclusion**

We agree that the demand side is important but do not believe that the arrangements set out under this proposal will facilitate additional demand-side response. Evidence from winter 2005/06 indicates that the price-responsive demand did make some response to high winter prices and we expect the market to develop to increase the responsiveness to short term market signals. The last few winters have demonstrated the ability of CCGT's to respond quickly and reliably to changes under, sometimes extreme, market conditions. We believe that as long as the signals are clear then the CCGT's will respond accordingly. Last winter's experience showed that CCGT's provide a very responsive source of arbitrage between the gas and power markets. During winter 2005/06 we saw considerable demand-side response from the generation sector and the establishment of a merit order for the demand-side. In our view the inherent flexibility of gas generation plant will place them higher in the merit order than large firm I&C customers and nothing should be implemented to distort this. This UNC modification proposal seeks to introduce fundamental regime changes ahead of next winter that we believe are unnecessary. For the reasons discussed above, we believe that the changes will blur the clear delineation of balancing roles and responsibilities that currently exist and undermine the efficient operation of the market. Suppliers are working hard to develop demand management products with consumers that respect their individual requirements, and centralised contracting would be economically inefficient and would thwart the development of the market. We believe that it will be more effective to focus on improving demand-side participation in the market rather than diverting demand-side involvement towards a centralised solution.

We hope these views are helpful and would be happy to discuss matters further.

Yours sincerely

*By Email So Unsigned*

Charles Ruffell  
Economic Regulation