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URGENT MODIFICATION PROPOSAL

Title : Use of Top Up to avoid excessive flexibility prices

Date : 26 January 1998

Proposed Implementation Date : Immediately

Urgency : Urgent

Justification :

Following prices of almost £5 per therm in the flexibility market on 16 and 17 December 1997, Ofgas expressed concern at the potential for excessive (and non cost-reflective) prices during the rest of the winter. They outlined a number of options which had been discussed at an industry forum on 18 December, and indicated a preference for increasing the utilisable rate of deliverability at Rough, if a modification were to be implemented.

Subsequently, Ofgas rejected modification proposal 205 on the strength of opposition which argued that the value of past investments to meet peak would be seriously undermined if it were to be approved. Ofgas expressed surprise that shippers appeared less concerned over exposure to such events in the future and more concerned about preserving the value of past decisions and recognised the risk to end customers which was not addressed. Ofgas also made clear that should similar events/prices occur again, they would investigate further and take action if necessary.

On 19 January 1998, a price of over 60p/th was averted only because of a stated AT-Link system failure, and a price of over 40p/th was reached on 20 January 1998. Bids included those for beach gas. While levels of 60p and 40p cannot be regarded as extreme, they still demonstrate further potential for artificial prices in the remainder of winter 1997/98, which could reach extreme levels. Notwithstanding the efforts being made towards a more comprehensive solution for winter 1998/99, Enron believes that a significant problem remains but a solution is achievable which will not only contain the risks to shippers and reduce costs, but also avoid a wholesale devaluation of past investments.

The following proposal supports the view that the value of peak gas on peak days should be preserved and does not excuse shippers who have made insufficient provision for their peak day demand. However, on a non-peak day, prices can be set at artificial levels not as a result of supply and demand conditions but purely as a result of some other instance of failure in the market. The proposal is intended to limit the risk imposed on shippers under these circumstances.

Even shippers who have made adequate provision for peak can be exposed to SMP prices as a result in delivery failure or failure to interrupt. Historical beach contracts typically do not offer protection against SMP cashout, and any such party who experiences a supply shortfall on a day could be exposed to extreme prices. Increasingly, end customers take the risk for failure to interrupt, which can now be unpredictably high.

Some shippers may argue that they have invested in additional gas at off peak times in order to profit from bizarre prices arising from the operation of the flexibility market. If the flexibility mechanism operated as an effective market, the price set by market conditions would rise more continuously as demand rose and this proposal is designed to help ensure that this happens. The elimination of artificial prices is a legitimate goal, even if windfall gains might be reduced for some players. Even these players would still see some advantage in reducing the potential cost of their own supply failure.

Consequence of not making this change :

On 17 December 1997, estimated losses associated with artificial pricing of £8-10 million were reported in the gas press. Future recurrences at potentially more extreme prices could cause participants to exit the market through bankruptcy or a re-evaluation of excessive risk, and may deter others from joining the market. It may at any rate lead to a loss of confidence in the traded market which would be detrimental to the development of competition.

A balancing neutrality charge of £16 million is estimated to have arisen from 17 December alone. This is a direct result of high prices which do not reflect supply/demand. On 17 December, ample gas was available at lower prices on the OTC market to allow shippers to trade out imbalances within day, which increased smearing costs. This will continue if not addressed. Flexibility bids paid by smearing charges create massive winners and losers which may again increase costs and deter participation.

Area of Network Code concerned :

Section P

Nature of proposal :

The level of N should be set dependent on the level of demand. On a peak day when V is above 100% (this can happen in a colder than 1 in 20 peak day or when a large section of interruptible demand remains on), the value of peak bookings should be preserved and N should remain at 50.

When V is less than or equal to 88%, firm demand can be met by Contracted Beach Supplies + Rough + Hornsea, which should be freely tradable. A value of N=1 would allow LNG holders to recover the cost of the most expensive LNG facility, but not to make a windfall gain. Other storage facilities could make a modest return on expenditure. Operating margins gas through Uncommitted Storage Deliverability would continue to be offered at the highest Top-Up Bid Price as defined in section P5.4.

Between 88% and 100%, there is no clear justification for other interim values ; we would suggest the following gradation to avoid excessive price discontinuity :

<u>V</u>	<u>N</u>	<u>Cap (p/kWh)</u>	<u>Cap (£/th)</u>
V ≤ 88%	N=1	3.2824p	£0.96
88% < V ≤ 90%	N=5	13.5320p	£3.97
90% < V ≤ 95%	N=10	26.3440p	£7.72
95% < V ≤ 100%	N=20	51.9680p	£15.23
100% < V	N=50	99.9999p	£29.31

The total deliverability from Top-Up and Emergency Top-Up is over 40 mcm/d. This additionally has the effect of ensuring that all Uncommitted Storage Deliverability is used (which is similar to the effect of Modification Proposals 205 and 205a) but Top-Up revenues count against the cost of Top-Up and reduce the charge to the industry rather than benefit a subset of shippers who hold gas under the Rough-Space Only Service. The increased likelihood of some Top-Up bids being taken should effectively reduce the cost of Top-Up to the industry.

The effect of establishing a lower Top-Up Bid Price would normally be to cap the market. There may be an exception where there is an extreme supply shortfall on a day when V is low. On such a day it is conceivable that all Top-Up Bids could be accepted, yet there is still a shortfall of gas, and System Buy Bids at more than £1 per therm may need to be considered. This is as it should be. Top-Up has been used to provide peak gas to redress the imbalance. Prices have been dampened, yet imbalance charges are still sufficiently punitive to ensure that interruptible supplies are off. Yet *in extremis* a higher price can be set if this reflects the supply/demand conditions. Shippers will be far less able to manipulate a high price which would not otherwise occur. Additionally, the costs of Top-Up would be reduced by actually using it when prices are high and decreasing the amount of surplus to be sold after the winter when prices are lower.

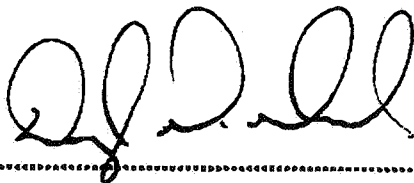
Purpose of Proposal/Achievement of Relevant Objectives :

The purpose of the proposal is to avoid excessive prices in the flexibility market which arise as a result of market mechanisms other than competitive supply/demand pressures. This will facilitate Transco's ability to improve the efficient and economic operation of the system, to secure more effective competition in the provision of flexibility, and to secure that no gas shipper or gas supplier obtains an unfair commercial advantage.

Proposer : Doug Wood

Position : Manager, Regulatory Affairs

Company : Enron Capital & Trade Resources Limited



Signed.....

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