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Our Ref:Net/Cod/Mod/0705
Direct Dial: 020 7901 7389
Email: steve.smith@ofgem.gov.uk

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Dear Colleague,

Modification Proposal 0705 - "Changing the basis for triggering supply demand interruption"

Ofgem[1] has carefully considered the issues raised in the modification report in respect of modification proposal 0705 "Changing the basis for Triggering the Supply and Demand Interruption".

Having had regard to the principal objective and statutory duties of the Authority[2], Ofgem has decided not to direct Transco to implement modification proposal 0705 because Ofgem does not consider that the proposal will better facilitate achievement of the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporters (GT) licence.

In this letter, Ofgem explains the background to the modification proposal and gives reasons for making its decision.

Background

Transco, part of National Grid Transco, is responsible for operating the National Transmission System (NTS) for gas in Great Britain. Transco has a number of statutory and licence obligations, regulated by Ofgem, that govern its ownership and operation of the transmission system. Transco also has in place a multi-lateral contract, known as the 'network code' that sets out the terms under which gas shippers can have access to, and use, the gas transmission system.

[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms Ofgem and Authority are used interchangeably in this letter.
[2] Set out in Section 4AA of the Gas Act 1986, as amended. Ofgem's statutory duties are wider than the network code relevant objectives and include amongst other things a duty to have regard to social and environment guidance provided to Ofgem by the government.

Transco's network code provides commercial incentives on gas shippers and suppliers to balance their inputs to, and offtakes from, the system by the end of the day[3]. These incentives are created by the 'cash out' arrangements that set the price that shippers pay for any imbalances at the end of the day. These arrangements are important for ensuring that the market delivers security of supply by providing incentives for gas producers, suppliers and storage operators to contract to meet their customers' demands and manage the risk of gas supply failures.

Transco, as System Operator (SO), has two principle roles associated with keeping the system in balance. Transco is responsible for residual gas balancing, to the extent that shippers' aggregate inputs and offtakes do not balance at the end of the day. Transco is also responsible for keeping the system in balance within the day over operational timescales. System balancing includes, for example, actions taken when there is a sudden loss of offshore supply or change in demand within-day and additional gas needs to be secured and delivered before the end of the day.

One of the tools that Transco has access to in order to balance the system is interruption. Transco may enter into interruptible agreements with users in which they agree to turn off or turn down their consumption of gas in certain circumstances. As specified in Transco's network code, Transco may instruct a user to interrupt in order for it to manage network capacity constraints; for the purpose of supply/demand balancing on high demand days; in an emergency; or for testing purposes. In respect of interruption for the purpose of supply/demand balancing on high demand days, paragraph G6.7.3(c) of Transco's network code sets out that Transco may call for interruption for supply/demand balancing purposes if forecast national demand is greater than 85% of the forecast 1 in 20 peak day demand[4].

Section G6.1 of Transco's network code concerns interruptible supply points. Paragraph G6.1.1 sets out that, where a supply point is eligible to be an interruptible supply point[5], the registered user may designate the supply point as being interruptible following notice to Transco. Paragraph G6.1.4 sets out that, in respect of the process to be followed for a supply point change of status, notice to Transco requesting to change status must be submitted two months before the Eligible Status Change Date (ESCD), which, under most circumstances, can be any date. However, in the case of a supply point which has recently changed to interruptible status, the ESCD is not less than 12 months after the most recent date on which the supply point changed status.

Transco may reject any request to change status. In the case of re-designation or designation as firm, paragraphs G6.3.1, 2 and 4 of Transco's network code set out that, where Transco determines and notifies the user that the "Firm Transportation Requirement" (FTR) is not satisfied, the designation or re-designation will not be effective and the supply point will continue to be an interruptible supply point. In summary, the

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[3] Although the network code arrangements only apply directly to shippers, these arrangements are relevant for other parties, such as suppliers, through the contractual and market arrangements in place.
[4] That is, peak aggregate daily demand which, having regard to historical weather data derived from at least the previous 50 years and other relevant factors, is likely to be exceeded (whether on one or more days) only in 1 year out of 20 years.
[5] The conditions for delegation as interruptible are set out in section G6.2 of Transco's network code.

FTR is described in paragraph G6.3.4 as the requirement that it would be feasible for Transco to make the maximum total amount of gas available at the maximum offtake rate at the supply point.

Transco distinguishes between standard interruptible supply points and Transco Nominated Interruptible (TNI) supply points. Under section G6.7.5 a standard interruptible supply point may be interrupted for up to 45 days each year, while a TNI supply point may face greater than 45 days of interruption. In addition, Transco may unilaterally designate an interruptible point (either a SNI or a TNI) as a Network Sensitive Load (NSL). Such loads, by virtue of their location, are more likely to be interrupted.

Section G6.1.9 of Transco's network code sets out that registered users of interruptible supply points receive two forms of 'payment' for being designated as interruptible. First, interruptible users do not have to pay NTS exit capacity charges or LDZ capacity charges. Second, where Transco nominates a supply point to be interrupted for more than 15 days in a particular year, the interruptible user will receive a transportation charge credit equivalent to 1/15 of the annual NTS exit capacity and LDZ standard capacity charges avoided by having interruptible rather than firm transportation.

Supply/demand outlook for this winter

National Grid Transco's (NGT) Preliminary Winter Outlook Report for winter 2004/5 published on 17 May 2004 identified a tightening of the supply and demand position for the coming winter due in part to a decline in the UK Continental Shelf (UKCS) gas supplies. The report identified that the market would need to deliver around 2 billion cubic meters of demand side response over a 40 day period in the event of a very severe, '1 in 50' winter. NGT has since updated its forecasts for winter 2004/5 in its final Winter Outlook Report published on 20 October 2004. This revised the required demand side response under 1 in 50 conditions to 2.4 billion cubic meters[6].

Transco network code Modification Proposal No. 0699: "Amendment to Transco's interruption rights for supply / demand purposes".

Shell Gas Direct (SGD) raised Network code modification proposal 0699 "Amendment to Transco's interruption rights for supply/demand purposes" on 19 May 2004. This modification proposal seeks to amend the current 85% limit to 90% from April 2005, with a further amendment to 95% from April 2006. The proposer considered that, by removing Transco's right to interrupt at lower demand levels, Transco would be more likely to seek market based options for demand management, i.e. through contracting on the On-the-Day Commodity Market (OCM) or through forward contracting, prior to instructing interruption. By increasing Transco's reliance on the market, the proposer was of the view that Transco have better incentives to reduce the costs it incurs in energy balancing and also that appropriate price signals would be sent to the market,

[6] The Winter Outlook Report stated that the 2.4 billion cubic meters requirement is broadly equivalent to interruption from the NTS and LDZ interruptible sectors (around 50 - 60 million cubic meters per day) at demands above around 410 million cubic meters, which, in volume terms, would be equivalent to the cessation of gas consumption for approximately 25% of all non-domestic demand over a 40 day period.

through the cash-out mechanism, as to the value of flexibility services. This proposal is currently still at the workstream stage.

As part of the assessment of modification proposal 0699, the proposal was sent to the relevant workstream for further development. As a consequence of the discussions at the workstream, Transco brought forward modification proposal 0705 as an alternative to 0699.

The modification proposal

Modification proposal 0705 was raised on 9 July 2004. The proposal seeks to amend Transco's supply/demand interruption rights by replacing the 85% trigger with the ability for Transco to initiate interruption for the purposes of operational balancing (that is, balancing the quantities of gas delivered to and offtaken from the NTS) where Transco determines that there is an operational balancing requirement which cannot be satisfied by taking any market balancing action (because there are no offers available to Transco which are operationally suitable).

The framework and principle governing Transco use of system management services, including the tools available to it to balance the System, is set out in its System Management Principles Statement (SMPS)[7]. In conjunction with modification proposal 0705, Transco proposed revisions to its SMPS to set out in more detail how it would operate under the arrangements put forward in the modification proposal. The proposed changes to the SMPS set out that the primary system management service available to Transco to use when there is an operational balancing requirement is the OCM. The proposed changes to the SMPS also set out that, prior to initiating interruption for supply/demand management purposes, Transco would seek to maximise the "efficient and economic opportunities" presented to it on the OCM. In seeking to maximise these opportunities the proposed changes to SMPS state that Transco would accept offers on the title, physical and locational markets taking into account the relative prices across all OCM markets and subject to the "operational suitability" of any offers based on the following:

- the expectation of achieving a change in gas flow rate in the appropriate direction;
- the potential effect of available offers on any prevailing stored gas requirement; and
- the ability to monitor changes in gas flow rates in the time period required by system conditions.

Transco would also allow time, where possible, for gas flows on and off the system to respond to the actions taken, and promote further availability of offers by making requests via existing shipper notification facilities.

The proposer was of the view that the proposed modification directly addresses the intent of proposal 0699 by ensuring that Transco would seek market based options for

[7] In summary, Transco is required by Special Condition 27 of its GT licence to prepare a statement in a form approved by the Authority setting out the principles and criteria by which the licensee will determine which system management services the licensee will use to assist it in the operation of the NTS and for what purpose.

demand management before resorting to supply and demand interruption. The proposer considered that the modification would require Transco to contract through the OCM if it considered that this was necessary to ensure supply/demand balancing. By relying on the market, the proposer considered that Transco would have better incentives to minimize the costs it incurs in energy balancing and also that appropriate price signals would be sent to the market as to the value of flexibility services.

Respondents' views

There were twelve responses to the consultation in respect of modification proposal 0705. One respondent offered qualified support for the proposal, and one respondent offered comments only. Ten respondents did not support the proposal.

Many respondents noted that there are other proposals being developed that are impacted by, or impact on, this proposal. It is suggested that this proposal be considered in conjunction with other relevant proposals and consultation documents, in particular modification proposal 0710, Ofgem's review of top up[8], and the proposed revisions to the System Management Principles Statement (SMPS).

Revised SMPS

A number of respondents noted their support for the revised SMPS while responding to this modification proposal. One respondent that did not support the proposal was of the view that they did not understand why the proposed revisions to the SMPS are linked to the approval of modification proposal 0705. This respondent also considered that whilst Transco retains supply and demand interruption rights, the SMPS should be modified to provide clarity to the market that it will take operationally suitable OCM offers before initiating interruption for supply and demand reasons. Another respondent who did not support the proposal was of the view that the implementation or otherwise of this proposal should not be contingent on the changes being made to the SMPS as the principle remains the same, that for Transco to maintain its role as residual balancer conditions need to be in place to give assurances that it will maximise the opportunities presented to it on the OCM before interrupting for supply/demand balancing purposes.

Interruptible triggers

In respect of the current trigger of 85% of peak day demand, one of the respondents who did not support the proposal commented that the present criteria of forecast total system demand exceeding 85% of system 1-in-20 peak day demand seems to be more predicable and auditable than a Transco determination about whether it can manage operational balancing requirements by taking market balancing actions. Another respondent who did not support the proposal recognised the difficulties with the current trigger being set at 85%, and expressed the view that an arbitrary number would not be appropriate in all circumstances.

One of the respondents who did not support the proposal considered that the existing arrangements for Transco supply and demand balancing interruption, alongside the amendments to the SMPS, would give users greater confidence that Transco is committed to relying on the market to respond first. This respondent was also of the view that it provided a clearer indication when Transco would have to interrupt, and reduces the current transparency by removing certainty as to when Transco can interrupt for supply/demand balancing reasons.

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[8] "The review of top up arrangements in gas – conclusions document" August 2004.

Supply side failures

Several respondents raised concerns that, with the removal of the 85% trigger, Transco could call supply/demand interruption to overcome difficulties that could arise as a result of supply side failures. One respondent who did not support the proposal stated that it changed the concept of what this category of interruption is required for from both shipper's and customer's perspective.

Operationally suitable market offers

A number of respondents who were not in support of the proposal expressed concerns that Transco would have more discretion in determining what is operationally suitable to instigate supply/demand interruption, and as a result would create more uncertainty within the process. One of these respondents stated that Transco could have inappropriate levels of discretion with respect to calling supply/demand management interruption, and that the effect of this would be to undermine market confidence and damage expectations that cash out prices would be allowed to rise to a level that enabled them to economically justify projects that stimulate the provision of both supply and demand side services consistent with meeting peak and off peak imbalances. Another respondent who did not support the proposal considered that the network code legal drafting does not provide the appropriate governance for the supply and demand interruption trigger.

"Insufficient offers"

The respondent who offered comments only expressed concerns regarding the draft legal text which accompanied the proposal, and opposed Transco having such a flexible right in the case where there are relevant offers available but these are, or may be deemed to be, "insufficient". This respondent recommended that the proposal should confer a clearer obligation in this case, and also considered that before resorting to interruption not covered by a market offer, Transco should be required first to accept all offers which would, or would be likely to, assist in satisfying the requirement. Furthermore, when Transco initiates interruption not covered by a market offer and any relevant market offer exists at that time that is not accepted, then Transco should provide evidence why the offer was not considered likely to avoid or mitigate the amount of interruption carried out.

Transco's views

As set out earlier in this letter, the existing 85% trigger allows Transco to call for interruption on any day where demand exceeds 85% of system 1-in-20 peak day demand. Transco, the proposer of modification proposal 0705, was of the view that, given the forecast tightening of the supply/demand position for the coming winter, the existing arrangements for supply/demand interruption could result in insufficient market response to protect firm supplies during a severe winter at demand levels below 85%. Given the existing 85% trigger, in this situation, Transco would not have the right to initiate supply/demand interruption and would therefore potentially be forced to declare a gas supply emergency in order to gain access to emergency interruption rights. Interruption called under such circumstances would not attract the payments to interruptible users as described earlier in this letter, therefore preventing a valuation of the interruption right. Emergency interruption would also generally be subject to a reduced notice period, providing the supplier and end consumer with less time to manage the consequences of such interruption requirement.

Transco was of the view that the modification proposal should be approved and implemented.

Transco noted the views expressed by users in response to the draft modification proposal about the use of the term “operationally suitable” to determine when to instigate supply/demand interruption. In determining whether or not any action would be operationally suitable Transco stated that it would consider:

- The ability of the action to be delivered and have a material effect on the system balance position within a suitable time period; and
- The ability to measure such delivery and effect.

Transco was of the view that it considered that the most efficient and economic means of fulfilling its residual balancing role is via the OCM. In this respect, market offers would be taken by Transco in accordance with the principles set out in the SMPS.

Transco also said that its commitment to use the market first and foremost before resorting to supply and demand interruption may potentially result in Transco taking more residual balancing actions on the OCM if users chose not to address their own portfolio management requirements. This would result in greater incentives on users that contract for insufficient gas to cover their customers’ demand to balance their positions in order to reduce their imbalance exposure. In addition, in the longer term, Transco considered that this proposal would facilitate the generation of efficient market signals for demand side participation through participation in the OCM.

Transco was of the view that the modification proposal would better facilitate achievement of relevant code objective 9(a) of Transco’s GT licence, for the efficient and economic operation of Transco’s pipeline system, by encouraging the efficient and economic use of the market whilst retaining the ’backstop’ ability to access supply/demand interruption before entering a gas supply emergency. In accordance with relevant code objective 9(c), Transco was also of the view that this proposal would seek to further secure effective competition between relevant shippers and relevant suppliers by further encouraging demand management where possible through the market.

Network code modification proposal 0710 “Removal of Top-up arrangements”

Transco said that although there are a number of modification proposals that have been raised in relation to top up and supply/demand interruption, all modification proposals are independent and should be considered on their own merits and on whether or not they better facilitate achievement of the relevant code objectives. Transco also considered that the revisions to the SMPS have been expressly proposed only in the event that modification proposals 0696 and/or 0705 are implemented and therefore Transco considered that these changes should not be implemented if both modification proposals are rejected. Transco recognised that, should modification proposal 0710 be implemented, then one or more of the benefits associated with this proposal would no longer be relevant. However, if the top up arrangements were removed, Transco was of the view that a requirement to interrupt for supply/demand management purposes would still be identified if forecast daily demand was in excess of available supplies and no appropriate market offers were available. In this respect, Transco considered the proposal was consistent with 0710.

Supply side failures

Transco confirmed that it can already call interruption to overcome a supply side failure when demand is forecast to be in excess of 85% of peak day demand, and that they can also call interruption to overcome a supply side failure when demand is less than 85% of peak day demand, provided that the impact on system pressures has the potential to impact the system's capability to flow gas and result in a transportation constraint. Transco was of the view that this proposal would reduce Transco's discretion in regard to supply/demand management interruption, and retain the existing arrangement in regard to interruption requirements to resolve transportation constraints.

Operationally suitable market offers

Transco was of the view that the term "operationally suitable" had been clarified in the SMPS consultation which accompanied this proposal. Transco also considered that a proposal based on exhausting the market of all available market offers, regardless of type would not, in Transco's opinion, have furthered the relevant objective to facilitate the economic and efficient operation of the pipeline system by encouraging the efficient and economic use of the market. Transco set out that, as required by its GT licence, it prepares an annual report for Ofgem on its compliance with the SMPS.

"Insufficient offers"

Transco was of the view that the intent of this proposal would take into account all operationally suitable market offers before quantifying the remaining volume of interruption that might be required. Transco also appreciated that this may not be clear from the original wording of the legal text and therefore proposed to remove the words "or insufficient".

Ofgem's view

Ofgem welcomes the close scrutiny that Transco and the industry has given to the existing interruption and cash out arrangements as part of the assessment of modification proposal 0705 and considers that it is timely that the industry is now re-considering the extent to which these arrangements provide appropriate price signals and commercial incentives on parties. It is Ofgem's view that this is especially important as Transco has indicated that it, as SO, considers that enhancements can be made.

Prior to setting out its views as to whether modification proposal 0705 would better facilitate achievement of the code relevant objectives, Ofgem would first like to comment on a number of points raised as part of its consideration of the proposal.

Interruption and the cash out arrangements

In its current role as SO, Transco undertakes two principal activities: residual gas balancing and system balancing across the entire gas network. In order to fulfil its obligations, Transco has a number of tools available to ensure that overall the gas system is operated in an economic and efficient manner. Interruption contracts are one of these tools. Ofgem considers that in order to promote economic and efficient operation of the system it is important that the costs of procuring and using these tools are appropriately targeted to users of the system.

As explained earlier, the current interruption contracts that Transco has in place with users of its system are a bundled 'product' as Transco utilises these contracts for both system and residual gas balancing purposes. Under the current standard interruptible contract terms set out in Transco's network code, Transco in effect pays an 'option' fee to secure the right to interrupt (effectively the transportation discount) but faces a zero exercise price when calling interruption for the first 15 days (there is an exercise fee for interruption beyond 15 days as Transco make defined payments when it interrupts a given site for more than 15 days in a given gas year[9]).

As a general principle, Ofgem considers that it is a matter for Transco, as System Operator, 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 coordinated manner. If they were to enter into or use bundled products, Transco must, however, be able to demonstrate that these are genuinely more efficient and lower costs to shippers and ultimately customers. There is a risk that Transco may simply structure these contracts to lower the cost to Transco under its incentive schemes and this could lead to higher total cost to shippers and customers. Transco must also, when entering into or using bundled products, have clear and effective rules to make sure that the costs of using these products for energy balancing purposes can be clearly identified and then fed into cash out price calculations. Otherwise, there is a risk that the use of these contracts may undermine the commercial incentives created by the cash out arrangements to promote security of supply.

Having carefully considered these issues, Ofgem has reached the view that one of the consequences of structuring the interruptible contracts with a zero exercise price is that the costs of using these interruption contracts for energy balancing do not currently feed through into cash out prices. Ofgem considers that this can cause the price signals provided by the cash out arrangements to be reduced. This could weaken incentives on the market to deliver secure supplies. In particular, in instances where demand for gas is high and there is a tight supply/demand balance on the system, and where it is important that balancing costs should be reflected in cash out prices, Transco is actually more likely to use its interruption contracts at a zero exercise price for supply/demand balancing purposes. Ofgem is therefore concerned about the absence of any mechanism to reflect the costs of interruption back to the market.

[9] It is necessary to review the current interruption arrangements as part of NGTs proposed DN Sales.

It is worth noting that Ofgem has recently established the Cash Out Review Working Group to undertake a wider review of the existing gas and electricity cash out arrangements. One of the issues that Ofgem has proposed the Group should consider is the way in which interruption and demand side reduction more generally should be priced and fed through into cash out.

The existing terms for interruptible transportation

As noted previously, Transco may enter into interruptible agreements with users in which they agree to turn off or turn down their consumption of gas in certain circumstances. In return for being designated as interruptible, registered users of interruptible supply points receive 'payment' in the form of reduced transportation charges and potentially a transportation charge credit.

For shippers and customers, their assessment of the desirability of interruptible transportation terms will be heavily influenced by their expectations of the level of interruption that they will be likely to face, and the likely costs associated with such interruptions, relative to the benefits that they receive through a reduction in charges as a result of being designated as interruptible. This modification proposal, if approved, would significantly change the likelihood of interruption by giving Transco much greater discretion over when it can call interruption. This would be likely to change an interruptible users' assessment of the relative costs and benefits of being interruptible. Ofgem considers that, as part of the assessment of this modification proposal, it would have been beneficial for Transco to consult with users directly on what they considered would be the likely effect of the modification.

Availability of demand side response

Transco, in support of modification proposal 0705, was of the view that the proposal, by encouraging the efficient and economic use of the market whilst retaining the 'backstop' ability to access supply/demand interruption before entering a gas supply emergency, would be beneficial for security of supply.

With respect to the availability of demand side response, although Transco does not currently have the rights to interrupt for supply and demand purposes at levels of system demand lower than 85%, this does not mean that the potential for demand side response from these sites is not available to Transco. Customers with interruptible transportation terms have demonstrated their willingness and capability to interrupt at least to some extent by securing interruptible terms. Whilst the mechanism would be different than through the provision of interruptible transportation terms, the current arrangements do not restrict Transco accessing demand side response via shippers through OCM or bilateral transactions. Transco also has the flexibility to enter into bilateral contracts, possibly at very short notice, directly with end-customers although these may have to be facilitated or executed via the customer's shipper. Therefore Ofgem does not consider that the current arrangements prevent Transco from accessing demand side response as they are not restricted to use of the OCM.

Modification proposal 0705

Having carefully considered the modification report, respondents' views and Transco's view, Ofgem, having regard to the code relevant objectives as set out under amended standard condition 9 of Transco's GT licence, considers that modification proposal 0705 will not better facilitate achievement of the code relevant objectives as, in summary, Transco has not properly considered the impacts of unilaterally changing the terms on which Transco can call interruption as put forward by the modification proposal. Ofgem's views are set out in detail below.

Relevant objective 9(a) of the GT licence – the efficient and economic operation by the licensee of its pipe-line system

Transco was of the view that modification proposal 0705 (and the proposed changes to its SMPS in support of the modification proposal) would commit it to use the market before resorting to interruption for supply and demand balancing purposes. Transco is of the view that the modification proposal also promotes security of supply.

Ofgem notes Transco's view but considers that it is possible, absent this modification proposal, for Transco to operate the system on the basis of using the market first. Furthermore, to the extent that it is Transco's view that the most efficient and economic means of addressing its residual balancing role is via the OCM, consistent with its statutory and licence obligations, Ofgem would expect Transco to operate its system in this manner.

Ofgem however recognises that it is important to promote the economic and efficient operation of the pipeline system to give market participants clarity as to the SO's role and how this role will be fulfilled. It could therefore be argued that some benefits can be expected to arise from formalising this approach through a modification proposal. Ofgem however considers that any benefits associated with such formalisation could be achieved by other means, such as a revision to Transco's SMPS statement[10].

As noted previously, Ofgem considers that extending Transco's rights to interrupt for supply and demand balancing purposes to cover all demand levels could at least potentially give rise to significant additional costs to those users with interruptible transportation terms. For such users, an evaluation of the desirability of interruptible transportation terms will be heavily influenced by their expectations of the level of interruption that they will be likely to face, and the likely costs associated with such interruptions, relative to the benefits that they receive through a reduction in transportation charges as a result of being designated as interruptible. Ofgem is of the view that Transco has not fully considered the potential impacts of modification proposal 0705. For instance, Transco has presented no supporting information as to what change in the likelihood of interruption could be expected were the modification proposal to be implemented.

[10] As noted above, Transco has proposed revisions to the SMPS that explicitly state that the primary system management service available to it to use when there is an operational balancing requirement is the OCM. Transco has, however, made its recommendation that this change be made to the SMPS conditional on modification proposal 0705 being approved.

Taking account of the above factors, Ofgem does not consider that the modification proposal would better facilitate achievement of relevant objective 9(a) of Transco's GT licence for the efficient and economic operation by the licensee of its pipe-line system.

Relevant objective 9(c) of the GT licence – securing effective competition between relevant shippers and between relevant suppliers

The modification proposal would involve Transco only being able to exercise its interruption rights when an operational balancing requirement could not be satisfied by taking available offers on the OCM that are 'operationally suitable'. Transco has argued that this change (together with a proposed change to its SMPS that Transco has recommended, providing this modification proposal is approved), would allow it to promote the further availability of offers on the OCM by making requests via existing shipper notification facilities.

Ofgem considers that, under the current arrangements, Transco, in its role as residual balancer, is already obliged to reflect any information that it has in respect of the current and likely future state of balance on the system to the market in order to facilitate an appropriate market response and thereby reduce Transco's system balancer role to as residual a level as possible.

However, as noted above, to the extent that any benefit would arise through formalising this obligation, Ofgem considers that, in this respect, the modification proposal would be likely to better facilitate achievement of relevant objective 9(c) of Transco's GT licence for securing effective competition between relevant shippers and between relevant suppliers.

Relevant objective 9(d) of the GT licence – the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

The cash out arrangements represent the mechanism by which the cost of balancing the system is signalled to the market, and thereby the commercial incentives are created for shippers to make adequate supply provisions for their customers. When Transco exercises its interruption rights for energy balancing purposes, the costs of interruption are not reflected in cash out prices. If the proposal was approved, it is possible that Transco would call interruption for energy balancing purposes more frequently. Under the current arrangements, this could reduce the incentives created through cash out to maintain security of supply.

As such, there may be some benefit in terms of incentives on market participants to secure supplies through Transco formalising the position that it will use the OCM first and foremost when acting as residual balancer, since cash out prices under such circumstances would be more likely to be cost reflective than would otherwise be the case. However, against this, the modification proposal seeks to extend the number of gas days on which Transco would have rights to interrupt to cover all days. Whilst it would only be possible to exercise these rights when there were insufficient OCM offers that are 'operationally suitable' to satisfy an operational balancing requirement, there remains uncertainty with respect to what impact this extension of rights could have on likely interruption levels (including, for example, in relation to the meaning of 'operationally suitable'). Ofgem does not consider that Transco has fully demonstrated that there can be expected to be a material net benefit associated with the proposal in terms of incentives on market participants to adequately secure supplies. Therefore, Ofgem does not consider that the modification proposal would better facilitate achievement of relevant objective 9(d) of Transco's GT licence for the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied.

Potential sale of gas distribution network businesses

Whilst Ofgem has made its assessment of modification proposal 0705 as set out in the modification report against the relevant code objectives, having had regard to the principal objective and statutory duties of the Authority, Ofgem has been mindful of the work currently being undertaken by it and the industry in relation to the potential sale of gas distribution network businesses.

Following any potential DN Sale it will be important that any arrangements for interruption for supply/demand purposes sit with Transco NTS in its role as residual gas balancer. The NTS and DN GTs would have responsibility for managing congestion on their network. Given this split of responsibilities in the proposed industry structure Ofgem considers that it is important that the issues discussed in this letter are addressed by Transco at the earliest possible opportunity to ensure that there is clarity in the roles and responsibilities and incentives between NTS and DN GTs.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct Transco to implement network code modification proposal 0705 because it does not better facilitate achievement of the relevant objectives as outlined under standard condition 9 of Transco's GT licence, and is consistent with the principal objective and statutory duties of the Authority.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Matthew Buffey on 020 7901 7088.

Yours sincerely

Steve Smith
Managing Director, Markets