



*Bringing choice and value  
to customers*

Shippers, National Grid Transco  
and other interested parties

Our Ref: Net/Cod/Mod/710  
Direct Dial: 020 7901 7389  
Email: [steve.smith@ofgem.gov.uk](mailto:steve.smith@ofgem.gov.uk)

18 October 2004

Dear Colleague

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

Ofgem<sup>1</sup> has carefully considered the issues raised in the modification report in respect of modification proposal 0710 “Removal of Top-up arrangements”.

Having had regard to the principal objective and statutory duties of the Authority<sup>2</sup>, Ofgem has decided to direct Transco to accept modification proposal 0710 because we consider that the proposal will better facilitate the relevant objectives of Transco’s network code under standard condition 9 of Transco’s Gas Transporters (GT) licence.

In this letter, we explain the background to the modification proposal and give reasons for making our decision. Annex A to this letter contains a summary of responses to the consultation on the impact assessment contained within the conclusions document on the review of top up arrangements in gas<sup>3</sup>, and Ofgem’s conclusions on the impact assessment.

### **Background to the proposal**

#### *What is top up?*

Top up refers to the gas that is held or placed in store by Transco in order to meet any shortfall that it identifies when its forecasts of gas supplies are compared with its forecasts of firm demand for the forthcoming winter under ‘1 in 50’ severe weather conditions. Transco undertakes this assessment process by setting ‘monitor’ levels for different categories of storage site that define the amount of gas that Transco considers would need to be held in store on each day throughout a given winter in order to ensure that demand in (what remains of) a 1 in 50 winter could be met. In addition to ‘filling’ any opening shortfalls (where there is available storage capacity), the top up arrangements require Transco to intervene in situations throughout winter where storage

---

<sup>1</sup> Ofgem is the office of the Gas and Electricity Markets Authority. The terms ‘Ofgem’ and the ‘Authority’ are used interchangeably in this letter.

<sup>2</sup> 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.

<sup>3</sup> “The review of top up arrangements in gas – conclusions document”, Ofgem, August 2004.

stocks would otherwise fall below these monitor levels by 'counter-nominating'. Transco's actions try to prevent gas being withdrawn from storage so that the volume of gas still in store is above the monitor level.

#### *Ofgas' 1998 review of top up*

The top up arrangements were put in place with the introduction of Transco's network code in 1996. Ofgas<sup>4</sup> reviewed the top up arrangements in 1998 and concluded that there should be no long-term requirement for a top up type mechanism<sup>5,6</sup>. Following the conclusions of the 1998 top up review, Ofgem approved a change to Transco's network code that means that Transco pays the net direct costs of providing top up gas. Prior to this decision, these costs were recovered from shippers and, ultimately, customers. Between 1998 and 2001, Transco sought agreement from the HSE to remove the top up arrangements from its Safety Case, which would have allowed the arrangements to be removed from the Network Code, but failed to secure HSE agreement.

#### *Why top up is a significant problem for this winter*

The potential for the current top up rules to lead to substantial direct costs to Transco, and substantial indirect costs to customers (through higher gas prices), has not been a significant issue in recent winters. This is because Transco's forecast levels of supply and demand in each year since 1998 have not required it to book significant storage capacity for top up gas or buy significant volumes of top up gas over the winter. For 2004/05, however, given its forecast of a tightening of the supply/demand position<sup>7</sup>, Transco indicated that the initial top-up monitor levels would be very high, with the Liquefied Natural Gas (LNG) Storage and Medium Range Storage (MRS)<sup>8</sup> initial monitors set at 100%, and the Rough monitor set at about 80%. These monitor levels would be likely to give rise to substantial Transco counter-nomination actions aimed at ensuring that monitor levels are not breached, even under average or mild weather conditions. Indeed, as the LNG and MRS levels are 100%, any early winter withdrawal from these sites would result in expensive Transco intervention. This highlights the prospect of substantial direct and indirect costs being generated by the top up arrangements in 2004.

#### *Ofgem's 2004 review of top up arrangements in gas*

In light of the issues above Ofgem initiated a review of the top up rules in May this year<sup>9</sup> and published its conclusions in August 2004<sup>10</sup>. The review focussed on whether, given market and other developments since Ofgas' review in 1998, the arguments for removing the top up provisions from the safety case and Transco's network code remained valid.

Ofgem's initial assessment contained within the May document confirmed the 1998 findings that the top up arrangements should be removed. The document highlighted substantial weaknesses with the current arrangements and explicitly noted that Ofgem considered the option of 'doing nothing' and leaving the arrangements in place was highly problematic. However, at that stage Ofgem was unable to clearly point to options that were not subject to significant uncertainty

---

<sup>4</sup> On 16 June 1999, the former regulatory offices, Ofgas and OFFER, were renamed the Office of Gas and Electricity Markets (Ofgem). References in the text to documents and events before this date use the name of the original regulatory office.

<sup>5</sup> "Review of top up gas, A Consultation Document", Ofgas, February 1998.

<sup>6</sup> "Review of top up gas, Conclusions", Ofgas, April 1998.

<sup>7</sup> Transco's preliminary forecasts for this winter are published in NGT's Preliminary Winter Outlook Report 2004/05.

<sup>8</sup> The existing MRS facilities are Hornsea, Hatfield Moors and Hole House Farm.

<sup>9</sup> "The review of top up arrangements in gas, Consultation document", Ofgem, May 2004.

<sup>10</sup> Op cit.

with respect to the likelihood of implementation ahead of the winter, and/or to the effectiveness with which they would address the identified problems. Given this situation, the potential need for decisions to be subsequently taken on an urgent timetable was explicitly recognised.

In response to this document, Transco put forward a proposal for the removal of top up. Ofgem presented this proposal in its August 2004 document, and this proposal forms the background to this network code modification proposal.

#### *Transco's proposal*

Transco's proposal is based on replacing the current top up arrangements with the concept of a safety monitor. This involves identification of a group of gas customers that, in a network gas supply emergency, can be physically isolated in a short period of time to ensure that they do not continue to consume gas. Once this group of customers has been identified, Transco would establish a series of 'safety monitor' levels at each storage site, which Transco has indicated will be at levels significantly below the existing top up monitor levels, to ensure that sufficient gas remains in store such that the demand of all customers that Transco cannot physically isolate in the required timescale could be met in severe conditions.

Transco would monitor storage stocks at each facility against the safety monitor and publish this information so that the industry could take action to ensure that the safety monitor levels were not breached. Under this proposal, Transco itself would not take action to avoid a potential breach unless Transco interruption was triggered by existing mechanisms (i.e. when Forecast Total System Demand exceeds 85% of System 1-in-20 peak day demand). If it appeared to Transco that the safety monitor would be likely to be breached, it would exercise its judgement regarding the risks associated with such a breach and take action accordingly. For instance, Transco may determine that it would be appropriate to consider re-allocation of the monitor levels between storage facilities.

In the event that the safety monitor was breached, Transco would call a network gas supply emergency using the rules and processes set out in Transco's network code, it would take action to ensure that the required volume of loads defined as 'protected by isolation' were no longer taking gas. This would ensure there was sufficient gas available to protect other customers.

#### *Ofgem's impact assessment*

Ofgem carried out an impact assessment on the removal of top up, in the context of Transco's proposal, within its August 2004 conclusions document. This provided an estimate of the pre-winter expected direct and indirect costs associated with top up counter nomination actions of over £200m.

On the basis of its impact assessment, and having considered the views of respondents, Ofgem remained of the view that top up should be removed from Transco's network code. Annex A to this document contains Ofgem's consideration of the responses received to this impact assessment and its conclusions in respect of this assessment.

#### *Safety case change*

Transco submitted a revision to its safety case to the HSE on 10 August 2004 to reflect the proposals contained within this modification proposal. The HSE approved the revised safety case on 1 October 2004.

## The Proposal

Modification proposal 0710 was proposed by Transco on 20 August 2004. The modification proposal seeks to remove the top up arrangements from the network code, which includes the following:

- the storage bookings and winter injection processes; and
- the calculation of storage monitor levels, stored gas requirement and top up market offer prices.

Transco proposed to replace the arrangements with an obligation on Transco to publish two monitor levels aggregated by storage facility type. The “Firm Gas Monitor” would cover total firm demand and would be published for information only. The “Safety Monitor” would cover those sectors of demand defined in Transco’s Safety Case. Transco would also publish periodic information in relation to each Storage Facility Type, highlighting the risk of a breach of the “Safety Monitor”, within operationally significant timescales. Where Transco became aware that the Safety Monitor levels had been, or were forecast to be, breached then Transco would liaise with the Network Emergency Coordinator (NEC) prior to the NEC declaring a Network Gas Supply Emergency (NGSE).

Transco stated that the purpose of this proposal was to ensure that it could continue to meet its obligations under its GT Licence (particularly those relating to the safe and efficient operation of the System) and was consistent with its obligations under its revised Safety Case (which, as we have noted above, has now been approved) whilst removing a potential source of distortion to competition in the wholesale gas and storage markets.

Ofgem agreed the proposed modification as urgent on 23 August 2004. In making this decision, Ofgem took into account the criteria it generally applies to such requests<sup>11</sup>.

## Respondents’ views

There were fourteen responses to this modification proposal: five were in favour of the modification proposal, seven were against the proposal, whilst two respondents submitted comments without making a specific recommendation. A further two responses were submitted after Transco had issued its Final Modification Report. Both of these respondents opposed the proposal, although one of these had already submitted a response to this effect within Transco’s original timetable. In Ofgem’s view, neither of these late responses raised new substantive issues not already dealt with in Transco’s Final Modification Report.

The respondents in favour cited the potential for adverse market operation and security of supply problems that top up may cause. Problems identified included the arbitrary top up pricing mechanism, the reduction in incentives on shippers to source gas to meet their customers’ demand and potential counter-nomination action by Transco which could lead to gas prices rising much higher than market conditions would warrant.

Although almost all respondents agreed that there were problems with the existing arrangements, eight respondents felt that there was not sufficient time ahead of this winter to make the significant changes to the arrangements proposed under this modification. Three respondents had concerns about whether customers would have enough time to understand the arrangements and respond appropriately by seeking to make arrangements ahead of the winter for commercial interruption, if appropriate. Another respondent considered that mechanisms

---

<sup>11</sup> [www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2752\\_Urgency%20Criteria.pdf](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2752_Urgency%20Criteria.pdf)

should be put in place to provide compensatory measures if the proposed change could be shown to impact on existing contractual commitments for this winter.

Alternatives to this modification that were proposed included improving understanding Transco's demand forecasting in order to reduce the top up monitor levels, amendment of the 'use it or lose it' rules to prevent a cycle of storage withdrawals and developing demand side mechanisms between end users, Transco and suppliers / shippers.

One respondent considered that the fact Transco would not be required to take any specific action prior to a potential breach was a welcome development given that it was consistent with placing a greater reliance upon the market to respond to a supply / demand imbalance. In contrast, another respondent felt that it may be more efficient for Transco to have ultimate oversight of security of supply in the event of a market failure.

Three of the respondents in favour of the proposal noted that the provision of timely information to the market was an important feature of this modification. They considered that, given the increase in information, the proposed arrangements should create strong market signals which would influence shippers to utilise storage and demand side bidding in a manner most likely to ensure that security of supply is maintained even under severe winter conditions.

Two respondents felt that if data is to be published by "storage facility type" it may leave certain storage sites at a commercial disadvantage. They also noted that publication of "real-time" storage flows would expose any operational failures and, unless such information were published even-handedly for all entry sources including production fields this would be unduly discriminatory. One respondent proposed an alternative solution involving the release of supplementary information only when there was a risk of the monitor being breached within 48 hours. This supplementary information would show, for the storage type the aggregate inventory at the start of the day, the relevant end-day monitor level and the current aggregate net nomination for that storage type. It also noted that the requirement for each Storage Operator to ensure Storage Terms permit Transco to publish the data should be a matter for the Storage Connection Agreement (SCA) and not the network code.

Two respondents thought that the setting of the monitor levels was opaque. One respondent felt that Transco should be required to publicise what customers or classes of customer fall into the categories "protected by monitor" or "protected by isolation" given that the safety case is not a public document. Another respondent wished to have greater clarity on how the safety monitor would be recalculated throughout the winter.

Three respondents noted that there could be potential problems with the fact that the LNG monitor levels may be set at a relatively high level and that relatively small stock changes could have a dramatic effect. Two of these respondents were specifically concerned that a breach of the LNG monitor could result in customers being interrupted for longer than necessary. This would be a risk if the decision on when end an emergency was related solely to the quantity of gas held in storage, given that the injection rates for LNG are so low. One respondent was concerned that the LNG monitor levels could result in market participants removing gas for LNG before it is necessary to ensure they have access to it before the end of winter, whilst another felt that holders of LNG will be aware that any gas below the safety monitor level would be inaccessible and that in some cases this could influence both the use of gas held and the future provision of LNG holdings.

One respondent considered that the breach of safety monitor level is too crude a tool to use without some reference to other information including the actual supply / demand position at

the time in question. It also had concerns that the interaction of prices before and after declaration of various stages of emergency that could lead to price distortion.

### **Transco's view**

Transco supported the modification proposal. It noted that the present regime might have a distorting effect on the gas market and that removal of the 'use it or lose it' arrangements would not remove all potential for such distortions. Transco also pointed out that removing the requirement for winter injections would reduce the direct participation of Transco within the gas market and is therefore more consistent with Transco's role as residual gas balancer.

Transco noted that the proposal permits it a certain amount of flexibility as the monitor levels are approached and said that in the event that the stock level approached the Short Duration Monitor it would seek to use such flexibility. This includes reference to the demand forecast which, particularly in the later weeks of the Winter Period may allow Transco to avoid declaration of an emergency. Similarly, Transco would seek to avoid a declaration where re-allocation of monitors between storage types would serve the purpose.

Transco recognises a linkage between Operating Margins gas which, amongst other purposes, supports orderly run-down of the system and the requirement for a LNG monitor. However it considers that the interaction is complex and that the orderly run-down provision is not designed to cater for the possibility that shippers' stocks are depleted to levels inconsistent with the requirement for a 1 in 50 winter. Transco has stated that it does intend to review this interaction fully prior to making the OM bookings for 2005/06.

Transco recognised the concern of storage operators regarding the provision of storage data and believes that the amendments made to the legal text for the modification are sufficient to address these concerns.

Transco reiterated that the conduct of an emergency would not be changed if this proposal were implemented and that the present emergency procedures already incorporate in principle, if not in words, the concept that certain sites are 'protected by isolation'. It also noted that the issue of management of an emergency in the post DN sale context is being addressed and would need to be whether this proposal was implemented or not.

Transco believed that sufficient clarity would be provided by the requirement on it to keep under review information already notified within that storage year and notify users of any changes. It also undertook to notify users at the earliest opportunity of any reassignment of storage monitors between storage facility types, if it has been unable to do so in advance due to the requirement to make a short notice decision to prevent the initiation of a gas emergency.

Whilst recognising the tight timescale, Transco believed that implementation of this proposal could be achieved for the 2004/5 winter, including the necessary information publication by Transco.

### **Ofgem's view**

Ofgem has carefully considered all of the respondents and Transco's views on this modification proposal 0710. Having had regard to its principal objective, Ofgem considers that this modification proposal better facilitates the achievement of relevant objectives (a), (c) and (d) of the network code.

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

Ofgem considers that the proposed modification would better facilitate the efficient and economic operation of its pipe-line system. The very high monitor levels that would apply for winter 2004/05 under the current arrangements generate a significant likelihood that Transco would have to take substantial top up actions to maintain defined levels of storage stocks throughout the winter even in situations where weather conditions are mild. These actions would be likely to give rise to substantial direct costs to Transco as a result of net losses from the purchase and sale of top up gas through the counter-nomination process. Furthermore, Transco's counter-nomination actions would be likely to generate significant indirect effects as these actions seek to restrict the availability of supply from a given storage facility, and to the extent that they are successful in doing this, result in the withholding of gas in store from the market during these periods. As a result, counter-nomination actions could result in significant increases in spot gas prices. They could also raise forward prices if the market assesses that it is likely that these actions would be repeated throughout the winter and/or in subsequent years. 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.

Since this proposed modification would remove the top up arrangements, it would remove the potential for what could be very substantial direct and indirect costs to be generated by counter-nomination actions under a range of weather conditions. Ofgem's August 2004 document included an impact assessment which considered the likely levels of direct and indirect costs that could be generated by the current arrangements in winter 2004/05 given Transco's assessment of the likely top up monitor levels for the winter. This impact assessment indicated that the pre-winter expected direct and indirect costs associated with top up counter nomination actions could be in excess of £200m. More recent increases in forward and spot gas prices and increased volatility suggest that this figure may represent a conservative estimate.

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

Ofgem considers that the proposed modification would be likely to better facilitate the securing of effective competition between relevant shippers and between relevant suppliers. As was noted above, the current top up arrangements could give rise to very substantial Transco intervention in the market - even in mild conditions - in attempts to avoid monitor levels being breached. This intervention (or an expectation of it) could have potentially significant impacts on competition in a number of ways. In particular:

- To the extent that the top up counter-nomination arrangements influence commercial incentives with respect to the use of storage facilities, they could be expected to distort competition in the provision of storage and related flexibility services. Most directly, the fact that storage is the only form of response that Transco contracts for when seeking to address an identified supply/demand shortfall could distort short-term trade-offs between sources of supply-side/demand-side response. Also, to the extent that the top up arrangements can generate higher winter prices than would otherwise be the case, this could potentially distort long-term investment signals with respect to storage and related forms of flexibility.
- Significant counter-nomination activity could be expected to increase levels of price volatility (and particularly so if this activity prompts increased levels of storage withdrawal), which could have a negative effect on market liquidity.

- The lack of robustness of the top up counter-nomination arrangements generates a situation where there would be a high probability of significant changes to the market arrangements being required within winter if counter-nomination costs were otherwise likely to approach levels referred to above. An increased likelihood of significant rule changes within winter could also be expected to have a negative impact on liquidity.

If implemented, this modification would remove the top up arrangements from the network code, and thus remove the potential for these negative impacts on competition to be generated by the top up arrangements. Whilst the proposed introduction of a safety monitor would result in monitor levels continuing to be applied at storage sites, the potential for the safety monitor levels to generate distortions to competition can be expected to be substantially lower than would be the case if the current top up arrangements were retained, given that the safety monitors would be set at levels substantially below the top up monitors that would be expected to apply.

We note the concerns expressed by a number of respondents with respect to the fact that a network gas supply emergency would be automatically triggered by a breach of a safety monitor. We would note that Transco's current assessment is that the monitor levels would be at very low levels (6% for Rough; 5% for Medium Range Storage (MRS); and 15% for LNG storage), and thus the likelihood of monitor breach would appear to be very low. Nevertheless, we would reiterate the comment made in our August 2004 Conclusions document that we would expect the consideration of the methodology for setting the safety monitor levels and the specific ways in which Transco should seek to ensure that the safety monitor is not breached to form the subject of further discussion with industry.

*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*

Ofgem considers that the proposed modification would be likely to be neutral, and at best slightly positive for security of supply. Ofgem does not consider that the current top up arrangements can be expected to have any material benefits with respect to security of supply, rather Ofgem is of the view that the detailed operation of the top up rules is such that the arrangements could in fact undermine commercial incentives on companies to deliver secure supplies. We would note that to the extent that the top up market offer price – the price at which top up gas is offered to market - has a material impact on the incentives on market participants to secure supplies, it is likely to be negative. In particular, if any alternative supply or demand side response can be expected to be available at times when a top up market offer might be accepted, but at a higher price than the top up market offer price, then the likely effect of the top up market offer arrangements is to reduce the price that would be faced by a shipper that has a supply shortfall under severe conditions.

Since the proposed modification would involve the removal of the top up market offer arrangements, it can be expected that this would have a neutral or slightly positive impact on 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.

Ofgem would also note that the current top up counter-nomination arrangements would be unlikely to be robust this winter even if conditions were mild, given the very high top up monitor levels that would be likely to apply under the current arrangements. They do not offer the industry the "insurance policy" that some respondents considered that the top up arrangements provide. In particular, there is a significant likelihood that top up counter-



nomination actions would result in additional storage withdrawals which would in turn generate further Transco intervention. Transco has indicated that under such circumstances it may consider that the declaration of a network gas supply emergency is necessary in order to shed firm load from the system to maintain gas storage stocks. As was noted in Ofgem's August 2004 document, this would appear to be a highly problematic use of the emergency arrangements (given that it is driven by commercial rather than safety criteria), and if such an approach were adopted, Ofgem would need to carefully consider the extent to which it was consistent with Transco's GT licence obligations. Nevertheless, this highlights the problems with the current arrangements, and we would note that increased levels of uncertainty with respect to the likely usage of the emergency arrangements would be expected to have a negative impact on commercial incentives to secure supplies and customers more generally.

This proposed modification would result in the removal of top up monitors and would thus remove this source of uncertainty. The proposal would, however, result in the introduction of safety monitors, and it would introduce an additional situation that could trigger a network gas supply emergency (i.e. for breach of the safety monitor). Whilst Ofgem recognises that this introduces an additional potential source of uncertainty, we would note that Transco's current assessment is that the monitor levels would be at very low levels and, as a result, the likelihood of monitor breach would appear to be very low. We consider that the proposed modification would reduce levels of uncertainty with respect to the likelihood of the emergency arrangements being triggered, and that the proposed modification would have a positive impact with respect to incentives to secure supplies.

#### *Other considerations*

In addition to the views set out above, Ofgem considered that it would be helpful to set out some further observations given some of the issues raised by respondents to this modification.

#### *Timetable for removal of top up*

As was noted above, there has been some industry criticism that the changes contained within this modification are significant and that insufficient time has been allowed for industry consideration. In addition, a few respondents commented that the market had contracted for this coming winter on the basis that top up will remain in place and one respondent thought that mechanisms should be put in place to provide compensatory measures should existing contractual commitments made for this winter be negatively impacted by these changes.

The potential need for decisions to be taken with respect to top up on an urgent timetable ahead of winter 2004/05 was explicitly noted in Ofgem's May 2004 consultation document. In addition, whilst the May document stated that Ofgem would have regard to the fact that the 2004/05 storage year is underway and therefore that shippers have adopted contractual positions on the basis of current arrangements, it was clearly emphasised that the nature of the flexible governance arrangements in respect of Transco's network code mean that the trading arrangements can be subject to change and revision by industry at any time.

Furthermore, the document explicitly noted that Ofgem considered 'do nothing' for 2004/05 to be a highly problematic option, and explicitly stated that:

*"Given the likely impact on the market of operating under the contract rules this winter, it is Ofgem's initial view that, other things equal, the setting of monitor levels in line with the assessment in NGT's Preliminary Winter Outlook Report – that is, the setting of opening levels of 100% at the LNG and Mid-Range Storage facilities, and 75% at Rough – would not be consistent with the operation of a pipeline system in an efficient and economic manner."*<sup>12</sup>

---

<sup>12</sup> "The review of top up arrangements in gas – consultation document" Ofgem, May 2004, para 5.2, p 31.

The Safety Monitor proposal was presented to industry in Ofgem's August document. Although the timetable for implementation ahead of this winter was tight, it was felt to be achievable and it was considered that the benefit of implementing these proposals ahead of this winter was considerable. Ofgem also notes that Transco believes that implementation can be achieved for the 2004/05 winter, including the necessary information publication by Transco. Whilst we recognise the timescale for consideration of the modification as a source of concern, Ofgem considers that it is outweighed by the substantial costs that would be likely to be generated by the existing arrangements.

#### *Preference for amendment of current arrangements*

Those that oppose the modification generally acknowledge that the existing arrangements cannot be left unchanged for this winter. However, they tend to favour amendment of the existing arrangements rather than their removal.

Ofgem does not consider that there is sufficient time to make the suggested amendments ahead of this winter, and there would in any case be significant uncertainty with respect to the likely effectiveness of any such approach. Under the existing top up arrangements, Transco has indicated that monitor levels would be 100% at LNG and MRS sites and 81% at Rough. It would take a significant alteration in the methodology to bring these down to levels where we would have comfort that the adverse outcomes we identified would not arise. Transco indicated that such a change would require HSE approval which could not now be achieved in the time available ahead of this winter<sup>13</sup>.

#### *Publication of storage information*

A number of respondents noted that an important part of this proposal involved the provision of timely information to the market. Ofgem agrees with this sentiment. However, two of the respondents had expressed concern that the proposal could leave certain storage sites at a commercial disadvantage.

Transco has worked with the storage operators to reach agreement as to a form of information provision that satisfies their concerns and has produced a note, attached as Annex B, which explains further the requirement for provision and publication of storage information. We understand that this has been accepted by all storage operators and we welcome such agreement. Some storage operators consider that it would be appropriate to review the operation of the provisions relating to publication of storage information following this winter and Ofgem would support such a review.

#### *Transparency of the methodology for setting monitors*

A number of respondents to the modification proposal expressed the concern that, as with top up, the methodology for calculation of the safety monitor levels seemed to lack any transparency. Ofgem considers that it is important the industry is able to understand the methodology and has therefore been in discussion with Transco regarding publication of its demand forecasting methodology together with further details regarding the calculation of the safety monitor levels. We would expect that publication of this information would occur shortly after the modification decision and that Transco would meet with interested parties to discuss any concerns they may have once the methodologies are published.

---

<sup>13</sup> We understand that HSE approval would have been required even if the recent revision to the safety case had not been approved.

### *Demand side mechanisms*

A number of customers have voiced concerns that the demand side mechanisms in gas are much less developed than in electricity and so it is not clear that customers would be able to offer a demand side response in the manner envisaged by Ofgem's analysis. 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.

### **Ofgem's decision**

For the reasons outlined above, Ofgem has decided to direct Transco to accept network code modification proposal 0710. Having carefully considered the merits of the modification proposal itself, Ofgem considers that it better facilitates the achievement of the objectives as outlined under Standard Condition 9 of Transco's GT licence. Ofgem also considers this decision to be 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 me on the above number or Matt Buffey on 020 7901 7088.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Steve Smith', with a stylized, cursive script.

Steve Smith  
**Managing Director, Markets**

## **Annex A - Ofgem's conclusions to its Impact Assessment on the removal of top up in the context of Transco's proposal**

### **Summary**

Ofgem is of the view that no new substantive issues were raised in response to its impact assessment of the removal of top up in the context of Transco's proposal. Ofgem therefore remains of the view that there are significant benefits associated with the removal of top up in the context of Transco's proposal and therefore that top up should be removed from Transco's network code.

### **Background**

In August 2004 Ofgem published its conclusions document in respect of its review of top up<sup>14</sup>. This document set out a proposal that Transco had developed that would facilitate removal of top up from its network code and its safety case. Ofgem considered that the removal of top up would be a significant change to the existing arrangements and should be considered 'important' under Section 5A of the Utilities Act. Ofgem therefore conducted an impact assessment of the removal of top up in the context of Transco's proposal which was published in its August 2004 conclusions document.

Ofgem's impact assessment of the removal of top up in the context of Transco's proposal indicated that top up should be removed from Transco's network code. As set out in this impact assessment, Ofgem was of the view the pre-winter expected direct and indirect costs associated with top up counter nomination actions could be over £200m. In addition, given Ofgem's view that top up counter nomination actions are unlikely to be effective in maintaining gas in store and its concerns over the mechanism by which top up gas is made available to the market, Ofgem was of the view that the removal of top up in the context of Transco's proposal would be likely to be neutral, and at best slightly positive, for security of supply. Further, Ofgem was of the view that the removal of top up in the context of Transco's proposal would be likely to lead to a lower level of interruption by customers than would otherwise be the case, particularly in mild conditions.

Ofgem invited views from the industry and other interested parties on its impact assessment. Seven responses were received, one of which was marked 'confidential'. The non-confidential responses can be found in full on Ofgem's website and a summary of the non-confidential responses is below

### **Summary of responses to the Impact Assessment**

No respondents commented directly on Ofgem's impact assessment. However, a number of respondents did comment on other elements of Ofgem's August 2004 conclusions document.

A number of respondents considered that the current top up arrangements should not be allowed to persist through this winter. One respondent expressed the view that, unless urgent action was taken, the existing arrangements could lead to unnecessary price spike should a cold snap occur in November. Another respondent expressed support, in general, of moves, which ensure Transco plays as residual part as possible in the wholesale gas market. In contrast, one respondent considered that it was more efficient for one party to have ultimate oversight of security of supply in the event of market failure.

---

<sup>14</sup> "The review of top up arrangements in gas. Conclusions document", Ofgem, August 2004.

There were a number of different views among respondents, however, as to what the most appropriate solution would be. A number of respondents agreed with Ofgem's conclusion that there were significant benefits associated with the removal of top up in the context of Transco's proposal. A number of respondents, however, expressed the view that other solutions, for instance amending the use it or lose it arrangements, amending Transco's methodology for calculating top up monitor levels, or allowing Transco to buy back storage gas in a manner less likely to create distortions in the market would be more appropriate.

A number of respondents commented on the timescale proposed for the removal of top up in the context of Transco's proposal. One respondent considered that, although Ofgem was of the view that it published its initial proposals in May 2004 in order that the industry would have sufficient time to assess and consider the impact of the removal of top up ahead of this winter, a number of possible outcomes have existed and therefore it has been necessary for industry players to plan on the basis of the existing regime.

In terms of the level of demand side response that could be expected in cold weather conditions, one respondent expressed the view that, although there is scope for demand side response in the event of high prices, it is extremely difficult, perhaps impossible, to make any accurate estimate of the level of response at particular levels of price. Another respondent commented that demand side mechanisms in gas are much less developed than electricity where users can and do contract with NGC for ancillary services and can lodge standing BM unit offers in the electricity balancing mechanism. This respondent suggested that Ofgem facilitate development of demand-side mechanisms between users, Transco and suppliers/shippers.

A number of respondents considered that the provision of timely information to the market was an important feature of this modification. It was felt that, given the increase in information, the proposed arrangements should create strong market signals which would influence shippers to utilise storage and demand side bidding in a manner most likely to ensure that security of supply is maintained.

## **Conclusions**

Ofgem is of the view that no new substantive issues were raised in these responses and therefore remains of the view that there are significant benefits associated with the removal of top up in the context of Transco's proposal and therefore that top up should be removed from Transco's network code.

## **Annex B – Transco’s proposal regarding storage information**

Storage Operators will provide, when required to Transco (initially in May of each year but also monthly as a check to ensure any changes are taken into account):

1. Aggregate Storage Capacity (space and deliverability) allocated to Storage Users. This is to allow Transco to notify Users, prior to the Winter Period, if insufficient Storage Capacity had been booked in order to meet 1 in 50 Winter demands in respect to the total firm load and/or the loads protected by monitor. (Q5.2.8 (a))
2. The capability of the Storage Facility in terms of space, deliverability and injectability. The deliverability information would ensure that Transco could, together with stock information, predict how the stock position would stand if withdrawals took place at maximum rate for two successive days (Q5.2.7 (b)). The injectability information would allow Transco to identify whether there were sufficient days prior to the onset of winter for the facility to inject sufficient gas into stock, assuming injection at maximum rate (Q5.2.8(b)).

Storage Operators will provide each day to Transco:

1. Stocks for aggregation by Storage Facility Type for publication of a weekly snap-shot of storage stocks (Q5.2.7(a)). Stocks provided by the Storage Operator would also be used, together with other information, to anticipate a breach in monitors
2. Injections and withdrawals so that, together with stocks, and (re)nominations provided on the day, Transco could anticipate a breach in one or more of the monitors. (Q5.2.7(b))

To retain confidentiality, the initial Storage Facility Types for the purpose of space aggregation and monitors would be:

1. Long Duration: Rough
2. Medium Duration: Hornsea, Holehouse Farm and Hatfield Moors
3. Short Duration: Glenmavis, Partington, Avonmouth and Dynevor Arms LNG Facilities.

It is believed that at certain of the smaller storage facilities a very small number of Users have gas-in-storage. Disclosing stocks on a facility basis might potentially, in conjunction with other information, reveal an individual User’s stock position. Information from CSL on the number of Rough Storage users would indicate that this would not apply there.

Transco will publish from this information:

1. Weekly, as snap-shots, stocks by Storage Facility Type (probably graphically on a web page on the same diagram as the relevant monitors). (Q5.2.7(a)). It is proposed that these snap-shots be published by noon each Wednesday and reflect the notified stocks at 06.00 the previous Monday.
2. As notifications where stock position was less than two days above the relevant monitor (assuming withdrawal at maximum rate), the amount of any excess stock and the extent (in kWh) by which the sum of the relevant withdrawal nominations exceeds the sum of the relevant injection nominations. (Q5.2.7(b)).
3. As notifications where insufficient capacity had been booked to meet one or both of the relevant monitors (Q5.2.8 (a)).
4. As notifications of potential breaches due to anticipated withdrawals or due to lack of days left within a pre-winter injection programme (Q5.2.8 (b)).

As notifications where renominations identified a potential breach not identified after nominations submitted at D-1 (Q5.2.8 (c))