

18 February 2005

Mr. Julian Majdanski
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Dear Mr Majdanski

Response to Draft Modification Report 727: Publication of near real time data at UK sub-terminals

As the proposer of the modification, energywatch fully supports its implementation. We have had heard no arguments during the course of debate on the modification that suggests that the costs or problems associated with the implementation outweigh the significant benefits that we believe would accrue to customers as result of the network code being changed.

Modification Benefits

energywatch has already provided estimates of the potential annual benefits of this modification. Our high level analysis suggests an annual benefit in the region of £265 million, excluding the benefit of better outage co-ordination given the time it may take to achieve coordination. On the costs, Transco has agreed that a £20 million one off investment, with a minor ongoing operational cost, is a reasonable estimate.

This modification will benefit customers to the tune of some £265 million a year. Even with the most conservative estimates of benefits we cannot imagine a scenario where the benefits do not justify an immediate change to the network code and timely implementation to ensure that customers reap these benefits sooner rather than later.

energywatch believes its analysis remains robust and the modification will deliver a clear benefit to the UK gas market and its customers. We request that the additional information attached to the DMR remains as part of the final modification report.

The Baseline

energywatch believes that Transco, and Ofgem, should only consider this modification against the baseline of the current network code. The agreement between producers and the DTI to deliver additional data at a point in the future is not relevant. Transco's DMR suggest that it is concerned that producers may withdraw the information that is currently being provided, which illustrates the key weakness of the scheme; it is voluntary.

Relevant Objectives

Ofgem will have to asses the proposal against Transco's relevant objectives, as defined in the licence (GT Licence ASC 9.1). Summarised below are energywatch's views on the better fulfilment of the relevant objectives:

(a) *efficient operation of the pipe-line system*

Transco's network relies on the incentives on shippers to self-balance. Where shippers are trading on the basis of limited information as well as information asymmetry they will be making sub-optimal decisions. They will therefore not be carrying out their own balancing in the most efficient way, leaving Transco a larger role as residual balancer.

The information provision will also improve the liquidity in the gas market over the longer term. It should make it easier for new entrants to join the market and give non-producers access to better data on which to carry out their business activities.

Finally, Transco's own actions should become more efficient as they will more reasonably be able to expect players to balance themselves, responding to the actual supply position on the day. Where Transco is forced to take balancing actions it should see greater liquidity in the within-day market as players, such as traders who may not be trying to balance a portfolio, will be more aware that balancing could be required and may offer their gas from store or alternative supplies they can access.

(b) *efficient discharge of Transco's licence obligations*

Transco's licence obligations can only be fulfilled efficiently if it receives good information and limits its own actions to the minimum required to maintain system safety. energywatch believes that this modification will help Transco in particular in fulfilling conditions:

ASC 4D – Shippers would benefit from a change to the code so as to receive the same information that Transco and some shipper affiliated companies already receive.

SC16 – Transco should get a better response from shippers in times of supply shortfalls allowing them to meet their security standards.

ASC 24 – energywatch notes that Ofgem has been awaiting flow information from the producers to allow it to conclude its price inquiry. Transco could in future provide the raw data to Ofgem. This would mean Transco could help Ofgem be an effective regulator.

ASC4 & SC41 – If flow information shows that the operation of certain terminals are causing balancing actions then Transco would be able to alter the code to allow some specific terminal charges, via a new methodology, reducing cross subsidies.

SC17 – Players would gain understanding about the way Transco balances, limiting their requirement to provide updates and reports.

SC27 – As well as improving the efficiency of market operation, the modification should also increase the offers of balancing services as more players would be aware of Transco's needs.

(c) *securing effective competition between shippers and suppliers*

Producers have suggested that the data provided under the modification would be of limited value due to the reliability of meters, flow variations from normal operations and the reducing field reliability. energywatch believes that if these arguments are true the producers should have no concerns about sharing the information. However, energywatch believes that this information is of value and it will therefore improve competition in the market if all players have access to this sort of data which shows the actual supply position in real time. Economic theory shows that information is a key driver in achieving efficient markets with high levels of competition.

(d) *incentivise suppliers to secure supplies for domestic customers.*

At the current time energywatch has concerns about the tools available for suppliers to secure supplies for their customers. With this modification shippers will be able to see any supply deficits arising and take appropriate action to meet a shortfall impacting their portfolios. This may mean taking gas out of store or increasing purchases at a specific terminal.

In the longer term a better understating of the operation of the physical system will encourage the efficient development of new gas supplies and balancing tools.

Increasing Competition

The benefits arising from the modification are derived from the impact that the data will have on the level of competition within the gas market. energywatch has undertaken some analysis of the benefits (annexed to the DMR) which we believe give a robust basis on which Ofgem can assess the modification. While the analysis is not extensive, the size of the benefits relative to the costs (by a significant factor) means that the case for change is clear. Even if Ofgem alters some of the data driving the calculations or assumes some double counting the case still remains extremely strong. energywatch would note that the benefits we have identified do overlap, with economic rent both increasing from improved efficiency but also shifting from those who have information to those who do not.

Theory - Economic theory supports the proposition that information is a key driver in determining the level of competition within any market. The degree of competition has a direct impact on the level of efficiency in the market; more information equals more competition. Both increased competition and improved efficiency of the market is in the interest of customers and all those players who are not currently party to the information held by the offshore producers.

Informed trading - The asymmetry of information concerning the physical operation of the gas network results in sub-optimal decision making. If this asymmetry is not addressed there is likely to be further concentration of market power and less effective competition. Gas producers and on-shore players (suppliers, traders and customers) with greater, common and robust information sources are likely to make more efficient decisions. These informed decisions about the physical position of the market will result in prices that better represent the true price of gas, such that at times of supply deficit prices should rise and at surplus, fall. Customers will therefore get “market priced” gas, and market players and new entrants will be able to better assess development options and respond to shortages in a timely manner, building storage, investing in new fields, etc.

Market entry – The withdrawal of the US traders and rationalisation in the power market has reduced the levels of liquidity in the gas market, leading to concerns about market entry. New entrants are more likely if the market is perceived as having the right balance of risks and rewards underpinned by transparency.

Sub-terminal verses regional - The UK relies on a variety of supplies supported by gas storage. During summer 2004 there were interruptions to customers in the south due to flows reducing through one terminal. This has illustrated that the market is impacted by terminal level flows, illustrating that zonal data does not provide the degree of transparency needed to understand within-day issues.

Maintenance data - Physical flows within a region can be affected by maintenance of the NTS. Transco is already providing detailed information on its maintenance programme to allow players to predict, understand and respond to the maintenance work. The network code already recognises the need for data impacting on shore gas flows to be made available. This modification is adding to that efficiency.

Maintenance co-ordination – Once flow data becomes common knowledge, producers and Transco will be incentivised to better co-ordinate their maintenance work, limiting the physical disruption to one period when all work is undertaken. Coordination would reduce costs and improve efficiencies, reducing times of supply deficit and lowering prices.

Timely response – To balance their positions and to meet customer demands the market incentivises shippers to respond to the physical position of the system. Information on gas flows

will enable players to better judge the actual demand and supply balance within the day. If supplies are falling from a large gas field, the sooner the market can make informed responses, the more secure the supply of gas will be.

Creating a level playing field - Over time players improve their understanding of the supply side, learning about the reliability of some gas fields, the daily swing in beach deliveries and price triggers for flows from flexible supplies. Traders have described to energywatch the process by which they would create a more detailed “market map” allowing them to trade in a more effective manner, ensuring that prices and market actions better reflect market fundamentals.

Market efficiency – This modification will increase the general level of efficiency in the supply chain as players with assets will operate them based on clear market signals. Likewise Transco would see players responding to the physical changes and should be able to rely more on a “market” response and where it does have to balance it should face lower gas costs.

Issues Raised by Transco

Legality – Transco’s DMR suggests that they feel it is illegal to allow this data to be published, breaching Section 105 of the Utilities Act. However, Transco points out that it can publish data required under the network code. energywatch would argue that as this modification is under the code, assuming Ofgem removes Transco’s licence derogation, Transco will be protected from the Utilities Act requirements.

energywatch would note that with meters owned by Transco the data will relate to flows through Transco’s pipes, coming from Transco’s meters and as such relates to their business and is not information being received from third parties. The modification is therefore in line with Transco’s licence - once the temporary derogation is removed, and the Utilities Act 2000, and it should not be viewed as an “extension” of the DTI initiative.

Transco argues that the data flows, even if they own the meters and the data, still relate to a third party business and should not be published. energywatch maintains that the commercial arrangements behind each terminal are private agreements between the parties concerned. The flow data will only reveal actual gas flows, not the relationship between flows and any individual party’s commercial “exposure”. If a party feels that they have a “risk” from flow data they can hedge the risk by altering contracts, for example moving the point of sale to the NBP rather than at the beach.

While Ofgem may have acknowledged the legal issues arising under the DTI initiative energywatch suspects this is because the data requirement was not in the network code and not data owned by Transco, rather than the Utilities Act being the hurdle. Furthermore energywatch notes that the Utilities Act gives Ofgem its primary duty to protect the interests of customers wherever possible by the promotion of competition. It would seem its primary duty outweighs other parts of the Act, which were unlikely to have been intended to limit the development of a transparent, competitive and efficient market.

Commercial exposure of producers – Problems on a production platform will not always immediately alter flows and operational agreements may vary flows without any supply problems occurring. Seeing gas flows does not automatically expose the producer to commercial risks. Where there are production risks, producers are best placed to manage them and can alter delivery points in contracts or use financial tools such as options to hedge risks through the market.

NEA liabilities – As NEAs are confidential it is difficult to comment on the substance of Transco’s concerns. However, as with all contracts these are open for renegotiation. energywatch would also expect there to be a clause in the NEA giving the network code supremacy over the NEA in the same manner as in storage connection agreements.

Meters – Transco’s concerns over metering imply that the best option for implementation is the purchase and installation of new instantaneous meters. Many businesses rely on metered data and are aware of the reliability issues surrounding them. However, meters are relatively reliable and accurate (normally within +/- 1.5%), and as Transco uses the data for managing its own network this is evidence of the value of the data. energywatch therefore feels Transco’s arguments against meters implies that they take a rather paternalistic approach to market participants, who we believe should be offered the opportunity to judge the usefulness of the data for themselves.

Frequency of reads – The conclusions on data provision frequency from the DTI initiative were shaped by the participants in those discussions, but not the wider market. energywatch remains of the view that real time data is of value to other players.

Withholding of information – In the DMR Transco raises concerns that the modification would result in producers withdrawing the data that they have committed to providing. energywatch would be extremely surprised if producers were to act in such a manner and would raise with DTI and Ofgem the potential competition issues associated with such action. As an associated policy development, energywatch would urge the DTI to put an information provision licence obligation onto producers to ensure that Transco is always given access to the information it needs to safely manage the UK’s gas network.

Conclusions

Ofgem’s principal duty is *“to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas so conveyed.”* energywatch therefore concludes that it is not in line with Ofgem’s principal duty to reject this modification.

If there are any issues raised in this representation please do not hesitate to contact me.

Yours sincerely

Lesley Davies
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