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The Joint Office, Relevant Gas
Transporters and other interested
parties

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29 July 2005

Dear Colleague

Uniform Network Code modification proposal 021 "Revision of the Emergency Cash-Out Arrangements"

Ofgem[1] has considered the issues raised in the modification report in respect of modification proposal 021 "Revision of the Emergency Cash-Out Arrangements" and, having regard to the principal objective and statutory duties of the Authority[2], has decided not to direct the relevant gas transporters to implement modification proposal 021.

The Authority has serious concerns about the adequacy of the consultation process and in particular whether all of the relevant issues and effects were set out sufficiently clearly and addressed so that respondents and the Panel could properly consider and comment on the proposal. For these reasons we are unable properly and lawfully to direct the relevant transporters to implement the proposal.

Ofgem does however consider that the issues that Transco NTS was attempting to address in raising this modification proposal are very important, particularly for the coming winter. We therefore encourage Transco NTS and other signatories to the UNC to consider whether further modification proposals should be raised to allow these important issues to be addressed ahead of this coming winter. Given the importance of these issues, Ofgem sets out below its current views on the merits of Transco NTS's proposal even though it has decided on procedural grounds not to direct the modification. It should be noted that these views are without prejudice to Ofgem's discretion in considering any future modification proposal.

[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.
[2] Set out in Section 4AA of the Gas Act 1986, as amended.

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In this letter, Ofgem:

i. explains the background to the modification proposal (pages 2-5);
ii. summarises the proposal (pages 5-6);
iii. summarises the views of the respondents and the Panel (pages 6-12);
iv. gives reasons for its decision (pages 12-13); and
v. sets out its views on the proposal (pages 13-25).

Background to the proposal

Current cash out arrangements in normal market operation

The current gas balancing arrangements are designed to provide shippers with strong commercial incentives to balance their inputs to and offtakes from the National Transmission System (NTS) by the end of the gas day[3]. Under normal circumstances, if a shipper is out of balance at the end of the day, any imbalance volume is cashed-out at prices determined by trades on the On-the-day Commodity Market (OCM). Different imbalance prices apply depending on whether the shipper is short gas or long gas[4]. A shipper that is short gas pays the system marginal buy price (SMP Buy) which is the highest price of any trade to which Transco NTS is a party on the OCM, excluding any trades that it takes for locational reasons[5]. A shipper that is long gas is paid the system marginal sell price (SMP Sell) which is the lowest price of any trade to which Transco NTS is a party on the OCM, excluding any trades that it takes for locational reasons[6]. Cash out prices are therefore designed to reflect the costs that Transco NTS incurs in buying and selling gas to balance the system each day.

In the event of a gas supply emergency, different cash out arrangements (as set out below) apply.

Current gas supply emergency cash out arrangements

Transco NTS, as Network Emergency Co-ordinator (NEC)[7], has specified a Safety Case[8], which sets out its procedures to deal with a gas supply emergency. The NEC Safety Case, in conjunction with the Gas Safety (Management) Regulations (GS(M)R) (1996), details the arrangements for co-ordinating the actions to be taken to prevent a supply emergency occurring or continuing. It includes an assessment of network risk and identifies two situations that would result in a Network Gas Supply Emergency (NGSE). The first is where there are insufficient gas supplies available to the National Transmission System (NTS) to meet demand. The second is where there is a critical transportation constraint in either the NTS or in a distribution network (DN).

[3] That is, in each 24 hour period beginning at 6am each day.
[4] See section F.1.2 of the UNC.
[5] Alternatively, SMP Buy is set at the system average price (SAP) of gas traded on the OCM plus a fixed value set at 0.0287p/kWh (which is based on the price for injecting gas into the Hornsea storage site in 2000) if this is greater than the highest priced Transco NTS trade. Note that if Transco NTS does not purchase any gas, SMP Buy defaults to this price.
[6] Alternatively, SMP Sell is set at SAP minus a fixed value set at 0.0324p/kWh (which is based on the price for delivering gas from the Hornsea storage site in 2000) if this is lower than the lowest priced Transco NTS trade. As for SMP Buy, the SAP related price is the default SMP Sell price if Transco NTS does not sell any gas.
[7] The named role for the NEC is the Director of Operations and Trading of Transco NTS.
[8] As approved by the Health and Safety Executive (HSE).

When Transco NTS identifies a supply shortfall that is unable to be addressed through the normal commercial arrangements, it will ask the NEC to declare an emergency situation. The NEC would then invoke all or part of the following five-step procedure as appropriate:

- **Stage 1 – notice of impending emergency**. This indicates that there is a potential gas emergency, where the information available to the NEC at Stage 1 indicates that there is sufficient time and sufficient gas available, for the primary system to be rebalanced without recourse to Stage 2. This would include maximising the use of linepack, storage and interruption; normal cash out arrangements apply during this stage;

- **Stage 2 – declaration of emergency**. At this stage the OCM is suspended and the primary transporter is instructed to carry out the measures set out in the emergency arrangements. After the OCM has been suspended, a new cash out price needs to be established. Under the current provisions of the UNC, the existing dual cash out price (as outlined above) is replaced by a single price during this stage[9];

  Currently this is calculated as the average of the System Average Price (SAP) for the 30 days immediately preceding the suspension of the OCM. Therefore, short shippers pay for any shortfall at 30 day average SAP, while long shippers are paid for any surplus at 30 day average SAP;

- **Stage 3 – firm load shedding**. The affected transporter makes direct or indirect contact with firm end-users and instructs them to stop or reduce their offtakes of gas. Firm load shedding is divided into three tranches of increasing severity and effect. The three tranches are:

  - very large end-users (VLDMC) (those taking more than 50 million therms per annum)
  - large end-users (those taking between 25,000 tpa and 50 mtpa)
  - end-users taking less than 25,000 tpa

  Firm load shedding will be invoked in the order shown above. It is at Stage 3 that exports of gas through interconnectors can be curtailed;

- **Stage 4 – system isolation**. The available gas would be allocated to secondary systems supplying domestic end-users;

- **Stage 5 – restoration**. Normal arrangements are restored.

The actions that Transco NTS and the NEC would take are set out in the NEC Safety Case.

Previous consideration of the appropriateness of the current arrangements

This section summarises briefly industry discussion and previous modification proposals in respect of the emergency cash out arrangements.

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[9] See section Q.4.2 of the UNC.

Gas Industry Emergency Committee (GIEC)

The Gas Industry Emergency Committee (GIEC) (and subsequently the Gas and Electricity Industry Emergency Committee (GEIEC)) has considered the appropriateness of the current emergency cash out arrangements. Areas identified for consideration included the effectiveness of incentives provided by a neutral emergency cash out price to encourage gas onto the system prior to the declaration of an emergency at Stage 2 and/or to reduce gas demand and the potential for perverse incentives not to alleviate or avoid an emergency occuring.

A number of modification proposals to Transco's network code have previously been raised to try to rectify the perceived problems with the prevailing emergency cash out arrangements.

Previous modification proposals

There have been a number of modification proposals to Transco's network code in relation to the emergency cash out arrangements, including:

- modification proposal 0294 "Change to Cash-Out following an Emergency";
- modification proposal 0502 "Changes to Commercial Arrangements in the Event of a Gas Supply Emergency";
- modification proposal 0568 "Changes to Commercial Arrangements in the Event of a Network Gas Supply Emergency";
- modification proposal 0582 "Changes to Commercial Arrangements for a Network Gas Supply Emergency"; and
- modification proposal 0635 "Changes in Gas Supply emergency Arrangements".

Details of these historic network code modification proposals are expected to be made available on the Gas Transporters Information Service Site (formally known as Nemisys) https://gtis.gasgovernance.com shortly.

Cash out review

In response to the various issues raised in the gas market in relation to the existing commercial arrangements in the event of an emergency situation, and in response to similar concerns raised through various modification proposals in the electricity market[10], on 1 March 2004 Ofgem published a letter setting out its intention to undertake a review of the cash out arrangements currently in place in both markets.

On 17 May 2004, Ofgem published a consultation document which identified those areas of the gas and electricity arrangements which it considered to be most relevant when addressing the incentives to balance and security of supply.

[10] These issues and concerns are raised in the network code modification proposals 0294, 0502, 0568, 0582 and 0635 referred to above. In the context of the electricity arrangements, similar issues are raised in the modification proposals P135 ("Marginal System Buy Price During Periods of Demand Reduction") and P138 ("Contingency arrangements in relation to the implementation of Demand Control measures pursuant to Grid Code OC6").

In September 2004 Ofgem established a cash out review working group (CORWG) the purpose of which was to assess, holistically, the issues relating to the electricity and gas cash out arrangements based on the consideration of a number of primary and secondary objectives[11]. The issues to be considered and the scope of the assessment were based on the May 2004 consultation document, with an additional call to the group by Ofgem for an examination and assessment of the cash out arrangements in emergency situations.

The main focus of the group in relation to the gas market was the emergency cash out arrangements. Two of the key areas considered by the CORWG were:

- the need to ensure that there are appropriate incentives to encourage Users to take appropriate actions through which a gas deficit emergency (GDE) might be avoided, or, its duration or extent reduced; and
- whether the 30 day average SAP was high enough to incentivise price sensitive gas to flow to the UK when a GDE has been declared.

The CORWG last met to discuss issues in relation to emergency gas cash out on 7 March 2005. The CORWG papers are available on Ofgem's website www.ofgem.gov.uk

NGT's preliminary winter outlook report – 2005/06

National Grid Transco (NGT) published its preliminary winter outlook report (WOR)[12] on 31 May 2005, which stated that NGT supported Ofgem's view that the current emergency cash out arrangements may not appropriately incentivise Users to take all actions that might avoid a GDE being triggered. NGT outlined that it intended to raise a modification proposal in this area.

In its covering letter[13] to NGT's WOR, Ofgem stated that it considers that the current emergency gas cash out arrangements do not properly reinforce the system of incentives designed to ensure that market participants contract for sufficient gas to meet demand in severe winter conditions. Ofgem agreed with NGT that the gas emergency cash out arrangements are critical to the efficient functioning of the market and therefore to security of supply.

The Modification Proposal

Against the background set out above, Transco NTS submitted modification proposal 021 on 1 June 2005 and requested that the proposal be granted urgent status. Ofgem granted the proposal urgent status on 2 June 2005[14].

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[11] The CORWG would primarily explore whether the cash out arrangements in electricity and gas: provide appropriate commercial incentives for market participants to balance their own positions and therefore deliver security of supply; and reflect the costs incurred by the relevant system operator when undertaking energy balancing actions as residual balancer and therefore provide appropriate signals to market participants as to the costs of supplying balancing energy in the relevant balancing period.
[12] 'NGT's preliminary winter outlook report – 2005/06', May 2005.
[13] 'Open letter – NGT's preliminary winter outlook report – 2005/06', May 2005.
[14] Ofgem's decision letter following Transco NTS's request for urgent status can be found on the Gas Transporters Information Service Site (formally known as Nemisys) https://gtis.gasgovernance.com.

In summary, this modification proposal seeks to address two elements of the gas emergency cash out arrangements:

1) To replace the current arrangements where shippers face a single cash out price whether they are long or short (set at the 30 day average SAP) with a dual price regime at the point of market suspension. Under the proposal:

   a) the emergency cash out buy price will be set to the prevailing SMP Buy price prior to the commencement of an emergency; and
   b) the emergency cash out sell price will be set to the prevailing SAP prior to the commencement of an emergency.

2) To introduce a new Emergency Interruption Volume (EIV) title trade and associated 'trade' payment. The EIV will be an approximation of the volume of gas that would have been taken off by the relevant offtake site had there not been interruption. The method of assessment of this volume would be the Offtake Profile Notification (OPN) with a number of alternatives, to be pre-determined, to be applied when OPNs are not available. The EIV will effectively be purchased by Transco NTS at the 30 day average SAP but also removed from the demand and supply flows of affected Users thus leaving their imbalance positions unchanged.

Respondents' views

This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received[15].

Sixteen responses were received in relation to modification proposal 021. Of these, two respondents, as well as the proposer, expressed support for the proposal and eleven stated that they were not in favour of implementation of the modification. One respondent offered qualified support for the proposal while another did not state a particular view but provided comments on the modification proposal.

Respondents who were against implementation raised concerns about a number of aspects of the proposal, including the content of the modification proposal and the lack of consultation by Transco NTS which they considered led to an incomplete proposal. Some of the respondents also expressed strong views in terms of the process followed for this modification proposal and considered that on process grounds alone this proposal should be rejected. However, a number of the respondents who were against implementation of the proposal nevertheless expressed support for some of the principles put forward. In this respect, of the ten respondents that were against the proposal, seven stated that elements of the proposal had merit but that either due to certain aspects that they did not agree with or due to the process that had been followed they could not support the proposal.

The respondents' views are set out in more detail in the section below.

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[15] Respondents views can be found on the Gas Transporters information service (formally known as Nemisys))
https://gtis.gasgovernance.com

Respondents supporting the proposal

The proposer was of the view that the current arrangements would not provide sufficient incentives on shippers to take all actions possible to avoid entering into an emergency or to minimise the duration of an emergency. It considered that the current arrangements could have an adverse impact on price sensitive gas because the 30 day average SAP would not be high enough to provide effective commercial incentives for gas to flow from Europe via the interconnector and to be imported through the Grain LNG terminal during stage 2 of an emergency when the market has been suspended.

Price

The proposer considered that any change to the cash out price should ensure that shippers would have no financial incentives to withhold gas from the system and to ensure that shippers would not have the incentive to withhold demand response and that these objectives can only be delivered by dual cash out prices. It considered that the most appropriate cash out exposure post market suspension should be close to the prices that were prevailing at the time of market suspension and therefore the SMP Buy price. The proposer also considered that using the SAP as the sell price would avoid a buy action setting the sell price if prices are escalating within day. The proposer was also of the view that changing the cash out price in stage 2 of an emergency would provide greater incentives on shippers/suppliers to manage their own portfolios and supply obligations.

Emergency Interruption volume

The proposer considered that the current arrangements for the treatment of Emergency Interruption would not target the costs to those shippers who have contributed to the emergency because, if those shippers were interrupted by Transco NTS, they would be made less short by Transco NTS's actions. The proposer was of the view that associating a title trade with Emergency Interruption would, to some extent, correct this lack of cost targeting. Therefore, under the proposal, if a shipper was short prior to Emergency Interruption, it would face the full extent of its pre emergency short position at the SMP Buy price. The proposer also considered that the 30 day average SAP is an appropriate level of payment for the emergency interruption because a higher price might reduce the commercial incentives a shipper faces to enter into interruption contracts with its customers and a lower price may not provide sufficient compensation for the cost of the gas sold back to Transco NTS.

The proposer considered that the modification proposal better facilitated relevant objective[16] (b) of the Gas Transporters' licence because increased security of supply standards should lead to more efficient utilisation of the pipeline system and also (e) because the proposal would generate reasonable, cost reflective and economic incentives to promote compliance with the domestic customer supply security.

The other respondents in favour of the proposal were supportive of any proposal which seeks to increase the incentives on shippers to manage their own portfolios and therefore would reduce the likelihood of a supply deficit. One of the respondents in favour of this modification proposal

[16] As set out in Standard Special Condition A 11 of the Gas Transporters licence.

considered that the EIV methodology should be included in the UNC for the purpose of any disputes and to ensure that the methodology is transparent to all, as did the respondent offering comments and the respondent offering qualified support.

The respondent offering comments and another respondent in favour of this modification proposal were of the view that the costs to the DNs would be immaterial and therefore should not be a barrier to implementation of the Emergency Interruption element of the modification proposal. These respondents also considered that the work necessary for this proposal to be implemented could be finished by 1 October 2005 if a decision was released before the end of July.

Respondents against the Proposal

Price

Cash-out Price – SMP Buy and SAP

Several respondents who did not support the proposal as a whole recognised that the implementation of a dual cash-out price would provide strong incentives on shippers to ensure they balanced their position. These respondents considered that this would assist in avoiding an emergency altogether or minimising the extent of any such emergency. Another respondent acknowledged that the prospect of being subject to SMP Buy would create a strong incentive on shippers to balance but highlighted that a similar proposal in the electricity market, BSC modification P135, had previously been rejected on the basis that it would permit a small volume of energy to set the price. The respondent suggested that this issue could be overcome by capping the cash out prices in stage 2 of an emergency as this would retain the relevant incentives without exposure to extreme cash out levels which may distort the market price.

Two respondents were of the opinion that it was less clear that the dual cash out price would provide an incentive on shippers to balance in situations where a GDE develops quickly as it may prove difficult for the shipper to react to improve its imbalance position and avoid the emergency. They considered that it would unduly penalise shippers in such circumstances, and a distinction should be drawn between progressive and rapid GDEs. However, of these respondents, one considered that the implementation of a dual cash out price may enhance shipper incentives to balance in situations where the emergency is progressive.

A number of respondents stated that the CORWG had previously reached an agreement that the retention of a neutral cash out price would be an important feature when the market was effectively 'broken'. Of these, one respondent cited that the proposed modification would introduce a penal cash out regime while another suggested that such a regime would provide shippers with an incentive to go long. Another respondent suggested that exposing shippers to SMP Buy for an extended period could, in certain circumstances, lead to shipper failure. One respondent also expressed concern that the use of SMP Buy may lead to prices being set at an inappropriate level the longer that an emergency situation were to persist. A further respondent outlined that in the absence of a neutral regime it would be necessary for Transco NTS to demonstrate that all opportunities for further gas to be flowed onto the system had been exhausted. Two respondents were of the opinion that a balance would need to be struck between the proposed cash out price and the current single 30 day average SAP.

Several respondents recognised the importance of encouraging flows of gas from continental Europe, through the interconnector. However they also recognised that price is not the only factor that influences the flow of gas and due to the lack of liberalisation in Europe, the changes proposed may not address the mechanisms required to encourage the gas to flow.

Impact on Shippers Incentives to Balance and to Deliver Gas during an Emergency

Several respondents cited that incentives to achieve a balanced position and buy gas to address any shortfall were already strong and licence obligations, existing cash out arrangements and the current level of forward prices created such incentives. In this respect, these respondents questioned the need for the current incentives to be reviewed. Another respondent recognised that although the modification may improve incentives on shippers to balance it was not possible to say this for certain as this has not been properly assessed. Two respondents considered that the modification proposal provided incentives to shippers to increase their flow of gas against their portfolio in order to ensure their capability to meet peak demand conditions. Two respondents considered that this proposal may have a corresponding impact on forward prices.

A number of respondents also expressed concerns about the ability of participants to react to the incentives provided by the proposed modification. These respondents were of the view that although shippers may have incentives to avoid being short, they may not have the ability to correct their imbalance position. In a similar respect a number of respondents were of the view that without additional quantities of gas actually available to the market, participants will have no ability to react to the high prices for gas shortfalls and the arrangements would just result in shippers facing more risk without any ability to manage it.

One respondent considered that following the suspension of the OCM, users would have limited ability to respond and take appropriate actions to balance their position because any trades taking place shipper to shipper would not be seen by Transco NTS.

Two respondents were of the opinion that the modification proposal would not assist in the promotion of security of supply. One such respondent stated that if a GDE were declared it would be apparent that certain aspects of the regulatory framework would have failed and that it seemed inappropriate to increase the risk faced by shippers in this regard.

Emergency Interruption Volume

Principles of the EIV

Several respondents who opposed the proposal supported the principle that the EIV is seeking to introduce namely that a shipper's imbalance position should not be altered as a result of Emergency Interruption initiated by Transco NTS. They also supported the principle that shippers who are short should not benefit financially from Transco NTS's actions. However, several respondents considered that re-negotiation of contracts between the shipper/supplier and customers that would be necessary if the proposal was implemented would be hard to complete in time for this winter. One respondent considered that many of the contractual arrangements are in place for this winter and if break clauses in these contracts do not exist, there would be no opportunity to renegotiate. This respondent was also of the view that it would have benefited from further involvement in the interruption process to ensure that it properly understood the process and the opportunity to achieve high rewards for interrupting and placing offers on the OCM.

One respondent did not support the principle of leaving shippers' imbalance positions neutral because it considered that it would discriminate against shippers with interruptible offtake points in favour of firm offtake points and producer affiliated shippers. This was because shippers with interruptible loads would only receive 30 day average SAP and would not have their balance positions rectified, whereas upstream shippers with firm demand could choose to interrupt their sites or bring more gas onto the system and be allowed to offset their imbalance position whilst getting a better, more reflective market price for their gas. Another shipper was unclear as to whether the EIV applied to firm loads as well. A further shipper considered that the prevailing market price prior to entering into an emergency would provide shippers with an incentive to initiate commercial interruption without the aid of this modification proposal.

<u>30 day average SAP payment</u>

Several respondents considered the 30 day average SAP payment to be an appropriate level of compensation to the shipper as it ensures the incentives are in place for the shipper to instigate commercial interruption. Another respondent agreed that the 30 day average SAP may provide adequate compensation to parties for the average portfolio cost of gas purchased prior to an emergency, however, in periods approaching an emergency, shippers may have paid close to the marginal price of gas to balance their position. Some respondents were confused as to whether the 30 day average SAP would feed into cash out prices and what its purpose was. One respondent considered that if the purpose of this payment was to hold shippers neutral, then maybe it would be better not to make such a payment. One respondent stated that the rationale for the level of payment was not clear.

<u>Information discrepancy</u>

One respondent considered that a shipper with an upstream arm would benefit from the proposed EIV at the expense of a shipper who does not have an upstream arm. This was because producers, especially those with interruptible sites would have prior knowledge that an emergency is imminent and could place offers on the OCM at market prices over and above the 30 day average SAP. This respondent considered that downstream shippers would have little notice of an imminent emergency and thus have little chance to interrupt their sites before Transco NTS instigated Emergency Interruption. This respondent therefore considered that the modification should provide more robust arrangement for short term information release.

<u>Section Q clarification</u>

Several respondents against implementation of the proposal were of the view that section Q of the UNC is unclear in relation to whether Transco NTS can take a market balancing action for the purpose of the EIV in a GDE because section Q 3.2.2 of the UNC seems to prohibit it. They also considered that although the revised legal text provided by Transco NTS went someway to addressing this, a closer inspection of section Q is needed.

Methodology

The majority of respondents not supporting this proposal expressed concerns over the methodology attributed to the EIV trade. These respondents considered that the methodology should be contained within the UNC to provide greater clarity and transparency for shippers. These respondents considered that any error in the calculation of the EIV volume would affect the shipper's imbalance position. An extreme over-estimate of the EIV would lead to the shipper facing high SMP Buy prices for a reason which was completely out of its control. This would go against the aim of the proposal, which was to leave the shipper neutral. Several respondents considered that it would be harder to manage the exposure to cash out because it would be difficult to estimate the volume adjustment in advance. One respondent considered that the information as to how a shipper's EIV was calculated should be made available after the event and to allow the information to be subject to challenge via a disputes process.

One respondent was unclear how Transco NTS would net off the EIV if the shipper has already interrupted the site and Transco NTS calls an Emergency Interruption to prevent the site from resuming the offtake of gas. This respondent was also seeking clarity as to what would occur commercially if a shipper had called an interruption with four hours notice, with the expectation that it may use the gas to alter its imbalance position and Transco NTS calls an Emergency Interruption within the four hour window.

Other issues

One respondent considered that the EIV part of this proposal would not achieve the desired results because most customers are resistant to commercial interruption contracts and would prefer to contract with Transco NTS directly for demand side services. Another respondent considered that it would be prudent for Transco NTS to contract forward with customers for balancing actions. This respondent considered that this would provide Transco NTS certainty that demand will turn down.

Process concerns

The majority of respondents raised a number of concerns about the process associated with this modification proposal. The general consensus was that it would have benefited from being developed and debated within the industry workstream and/or the CORWG which would have led to a more robust and better developed proposal. Several respondents considered that making the emergency arrangements more complicated this close to winter would not be advisable. It was also considered that raising this modification proposal via the urgent route with no chance for development meant that respondents had insufficient time to understand and respond to the proposal and therefore the impact on parties may not have been considered fully. Some of the respondents considered that on process grounds alone this proposal should be rejected. One respondent also considered that if any unintended consequences were missed due to the shortened timescales, the Final Modification Report (FMR) may not be comprehensive enough for Ofgem to make a robust decision in line with its statutory duties.

Panel recommendation

The Panel voted 7-3 against implementation of the modification proposal. In the FMR there is no record of any reasons as to why they voted the way they did.

Ofgem's view

The Authority has carefully considered the views of all the respondents, including Transco NTS, on modification proposal 021. Having had regard to the Authority's statutory and wider public law duties, the Authority concluded that it must reject the modification proposal on procedural grounds.

This section first sets out the reasons for the Authority's decision to reject the modification proposal on procedural grounds. It then goes on to set out Ofgem's current views on the issues that the proposal raises. These views are without prejudice to the Authority's discretion in considering any future modification proposal.

Procedural issues – reasons for the Authority's decision

In considering respondents' views, the Authority was concerned with the number of respondents that identified potential procedural deficiencies associated with this modification proposal. Although the Authority was satisfied that the issues raised are sufficiently important to justify urgent status, having reviewed the process, the Authority considers it regrettable that the proposal was not raised earlier in the year to allow more time for consideration before the winter. The Authority noted, however, that it had highlighted the need for the industry to review the emergency cash out arrangements on a number of previous occasions over a number of years, including in decision letters on previous modifications and at the beginning of the CORWG. Both shippers (including a number of the respondents concerned about the process) and NGT could have raised a proposal designed to address these issues.

The Authority was also concerned that respondents had less than 24 hours to review key legal text associated with the volume calculation. Overall, it was clear to the Authority that the process could have been substantially better in considering a modification proposal of this nature.

Following receipt of the Final Modification Report, having consulted Transco NTS in relation to the intention of key parts of the legal text associated with the modification proposal, it became clear to the Authority that it was unlikely that respondents to the consultation process properly and fully understood the intent of the proposal. As set out below, Transco NTS believes that the legal drafting of the proposal limits the application of the EIV title trade to Transco NTS interruption of interruptible supply points and not to actions to interrupt firm load under emergency conditions. The Authority did not think that this important feature of the proposal was clearly set out in the modification report and it was not clear, from responses to the proposal, that respondents had understood the precise nature of the modification. This was clearly a deficiency in both the description of the modification and the consultation documentation.

The Authority considered that this flaw in the modification process was of sufficient materiality that it had no alternative but to reject this proposal on this basis, as it could not lawfully accept a proposal upon which proper consultation had not been possible.

In this light, Ofgem considers that Transco NTS should, as a relevant gas transporter, alongside other relevant gas transporters, urgently review its procedures including the Joint Office to ensure that no such material deficiencies in the process of urgent modification proposals arise in the future.

Ofgem's views on the issues that UNC Mod 021 was seeking to address

The Authority does however continue to consider that this is a key issue that needs to be urgently addressed ahead of this winter. In the event that Transco NTS or any other signatory to the UNC were to raise further modifications in this area, it is likely that urgent status would be granted. The Authority considers that it is important that these issues are addressed as expediently as possible given the concerns raised by respondents concerning the potential impact on commercial contracts ahead of the winter.

Notwithstanding our rejection of the modification on procedural grounds, and without prejudice to the discretion of the Authority in considering any future modification proposal, Ofgem considers it is important to set out our views on the detail of modification proposal 021 in order to facilitate clarity and expediency in relation to any future modification proposals in this area. Ofgem considers that there are elements of the modification proposal which could potentially better facilitate the relevant objectives, and elements of the proposal which require more consideration.

Below, Ofgem briefly summarises its views on the shortcomings of the current arrangements before providing our views on the positive and negative aspects of the modification proposal as drafted.

Shortcomings of the existing regime

The cash out arrangements are designed to provide commercial incentives on shippers to ensure that inputs of gas onto the system match the offtakes of gas from the system, leaving only a residual role for the System Operator in balancing the overall level of supply and demand. Cash out prices should reflect the costs incurred by the System Operator in balancing the system – for example, if the system is short overall, the cost of buying gas or demand side response. When the market is tight, cash out prices are likely to be high and this creates the incentive on shippers to balance.

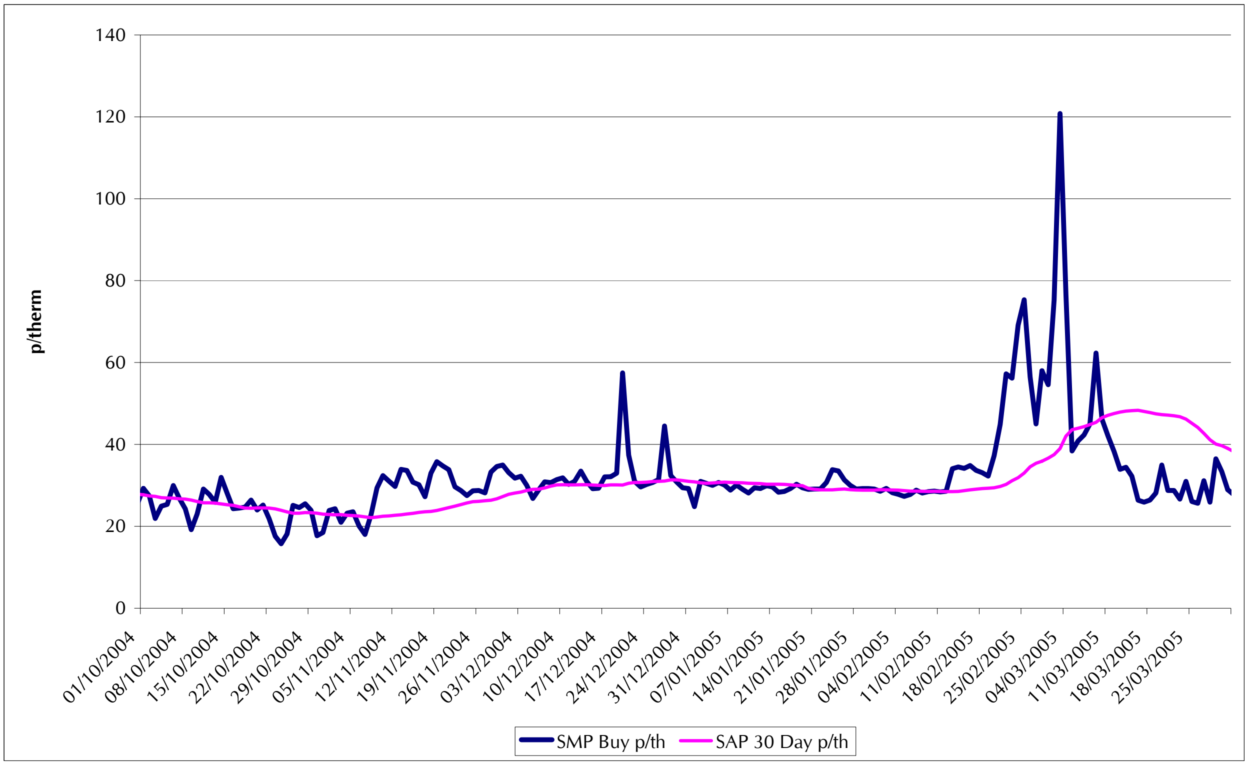
Ofgem considers that it is critical that the cash out arrangements leading up to and during a gas deficit emergency continue to provide shippers with appropriate commercial incentives to balance their inputs and offtakes on to the system. In the absence of appropriate commercial incentives at this critical time, Ofgem is concerned that the likelihood of a gas deficit emergency is increased, and that the duration of any emergency could be longer than would otherwise be the case.

Ofgem has highlighted its concerns with the current gas emergency cash out arrangements and has repeatedly called on the industry to consider reforms to the current arrangements. Ofgem continues to consider that the current arrangements potentially create perverse incentives for shippers who are short of gas when the overall supply/demand balance in the market is tight. The current arrangements do not appear to provide shippers with an incentive to try to balance their inputs and offtakes in these circumstances and, by having a less onerous cash out regime in an emergency situation than immediately prior to one, may encourage shippers to move further out of balance to trigger an emergency which could potentially have the effect of reducing their commercial exposure under the emergency cash out arrangements.

The current emergency cash out arrangements, where the cash out price of any imbalance is almost certain to be lower than it would have been immediately before the emergency was called and well below the cost of balancing the system creates two significant problems in an actual or potential GDE:

- there is a risk that the current arrangements will fail to attract price sensitive sources of gas (for example Norwegian gas, gas from NW Europe through the Belgian interconnector or imported LNG) that can be diverted to other markets either in Europe or further a field which could either prevent or resolve an emergency situation. It is important to note that these price-sensitive sources of gas may well be beyond the reach of the "command and control" arrangements under section Q3.3 of the UNC and Regulation 6 of the Gas Safety (Management) Regulations 1996 (compliance with which would in any event be difficult to police);
- shippers have a weaker incentive to contract with customers for demand response to get back into balance and prevent a gas emergency.

Clearly, given the prospect of a tight demand and supply situation this winter and the increasing reliance of the GB market on price sensitive sources of gas from LNG and interconnector imports, the significance of these shortcomings is increasing over time. The potential impact can be illustrated with reference to the cold snap at the end of winter 2004/05. The chart below shows what would have happened to imbalance prices if the GB market had entered a gas deficit emergency during last winter. The blue line shows the cash out prices that applied during this period. The pink line shows the cash out prices that would have applied (calculated under the current rules as the 30 day average of the system average price in an emergency).



It is clear that the emergency cash out price would have been considerably lower than the cash out price under non-emergency conditions. If there had been a gas deficit emergency during this period, and shippers that were short of gas had faced a price for the volume of their shortfall based on 30 day average SAP, they would have had little incentive to pay high prices to buy additional gas from North West European markets (where gas was trading at around 120p/therm[17] – significantly above the 30 day average SAP) to balance their position.

Against the background of these shortcomings, we now turn to the details of modification proposal 021.

Standard Special Condition A 11 (a) – the efficient and economic operation of the pipe-line system to which this licence relates

Price component

For a shipper that is short of gas, Transco NTS's proposal will result in the emergency cash out arrangements being modified, so that rather than being charged the 30 day average SAP for its shortfall of gas, the shipper will have to pay SMP Buy for its imbalance.

The SMP Buy price is likely to better reflect the prevailing market price for gas (and the value of the gas during an emergency) than 30 day average SAP. This is likely to be artificially low (since the

[17] Gas prices in Zeebrugge at the day-ahead stage were at or upwards of 120p/therm.

price is based on a 30 day average, it could reflect gas prices for mild weather conditions as well as those in the run up to the emergency). Therefore, this aspect of the proposal is likely to provide considerably stronger incentives to those shippers who are short of gas in the days or hours leading up to an emergency to procure gas or demand side response from market sources and, therefore, to address their imbalance through the normal market mechanisms. Under the proposal, given parties will be able to trade on the OTC markets, parties that are exposed to SMP Buy would have an enhanced incentive, relative to the current arrangements, to source gas from price sensitive sources including the interconnector and LNG imports to the extent that the price of these sources of gas is less then SMP Buy. By improving the incentives for all shippers to balance their positions in situations where the gas market is close to an emergency, it follows that the likelihood of a stage 2 emergency occurring is reduced. Equally, the change in the incentive of shippers that are short of gas should result in an emergency being shorter in duration than would have otherwise been the case under the current cash out arrangements.

Ofgem considers that the modification removes the current perverse incentive in which a shipper that is short of gas may gain financially from the overall system entering a stage 2 emergency and therefore is positively discouraged, from a financial perspective, from addressing a short imbalance (and alleviating the overall gas deficit). Ofgem notes the views of several respondents that the reputational damage associated with pursuing such a strategy is likely in their view to act as a constraint even in the absence of the proposed modification. However, experience from energy markets and elsewhere suggests that during periods of very high prices, shippers' exposures could be very large. In these circumstances financial incentives are likely to carry most weight . Reputational risk would also be discounted as after an emergency, it would be very difficult to assess whether companies genuinely did all they could to, for example, secure demand side response.

Ofgem therefore considers that exposing shippers to SMP Buy when they are short of gas in an emergency rather than 30 day average SAP will promote the economic and efficient operation of the pipeline system by placing significantly stronger incentives on shippers to balance their inputs onto and offtakes from the network when the system is close to and during an emergency than currently exist at the moment.

For a shipper that is long, Transco NTS's modification proposal would result in the cash out price being set to SAP (as calculated for the day on which the emergency was declared) rather than 30 day average SAP. Since SAP is very likely to be greater than 30 day average SAP in the run up to a gas emergency, this is likely to provide an additional incentive for long shippers to provide more gas onto the system particularly from price sensitive loads such as the interconnector relative to the current arrangements. We would expect that shippers who are long to attempt to contract with shippers who are short, since those shippers would be willing to pay a price up to SMP Buy to reduce their imbalance.

Ofgem therefore considers that through paying shippers that are long the SAP rather than 30 day average SAP will promote the economic and efficient operation of the system through encouraging price sensitive sources such as the interconnector or LNG Storage to flow into the GB market.

Although Ofgem considers that the above aspects of Transco NTS's proposal are likely to better facilitate relevant objective (a), Ofgem does however, consider that there are a number of areas in relation to which the modification proposal could be improved in relation to the price component. For the avoidance of doubt, it is obviously for parties to the UNC to consider whether these or further areas should be addressed for this winter or in the medium term. Ofgem will consider all proposals and cases for urgency on a case by case basis but is minded to grant urgency to any proposal designed to address the short term issues identified in this letter.

These improvements broadly fall into two categories:

- improvements that we consider would need to be introduced in advance of this winter, and are therefore critical to the emergency cash out arrangements; and
- improvements that we consider could be considered over the medium term to refine the arrangements proposed.

In relation to the first of these categories, Ofgem notes above that some respondents have raised the concern that it would not be possible during an emergency to trade out imbalances. As we describe above, the ability to trade out imbalances in the face of cash out incentives is key to a significant proportion of the potential benefits of this modification. Ofgem has given careful consideration to this issue and requested clarification on the interpretation of key provisions of the UNC from Transco NTS. Transco NTS have given Ofgem assurances that the UNC provides for them to accept nominations in relation to OTC trades during Stages 2 and 3 of an emergency and that they will in any event operate the system so as to allow such nominations. However, Transco NTS further stated that the relevant section of the UNC (Section Q) is currently under review and acknowledged that this is an area where greater clarity is desirable prior to this coming winter. Transco NTS has undertaken expediently to bring forward modification proposals following this review.

Ofgem welcomes the review that Transco NTS is conducting and considers that it would be important for there to be clarity in this area in order that shippers could be confident that the modification would operate as intended.

Several respondents noted that the use of the pre-emergency SMP Buy price as an emergency cash out price may result in the purchase of a small volume of gas by Transco NTS setting the cash out prices for a long period of time during an extended emergency. Respondents also noted that, in relation to modification proposals in the electricity market, Ofgem had previously argued against such an approach. While the issues around small volumes of gas setting the cash out price in gas are possibly less significant than they are in electricity, as a result of the longer balancing period, Ofgem continues to consider that a more aggregated form of "marginal" pricing (for example a price based on some combination of the most expensive trades taken on the day) may be more appropriate than pure marginal pricing. One possible way to address this problem would be to set a *de minimis* volume of gas which would set the marginal price or alternatively by setting the marginal price equal to the average of a fixed number of the most expensive trades that Transco NTS and /or market participants undertake on the OCM prior to a stage 2 emergency being declared. Again, we consider that this is an area which would benefit from further thought and development.

There are a number of areas for potential improvements which we consider fall into the second category of issues that Ofgem consider should be addressed in the medium term.

Although Ofgem considers that aspects of Transco NTS's proposal in relation to the price component better facilitate the relevant objectives, consideration should be given to whether SMP Buy and SAP will provide appropriate incentives, particularly in the event that a gas deficit emergency continues for a prolonged period. The SMP Buy price places an effective cap within the OTC markets which may create risks for the economic and efficient operation of the system. Similarly, the SMP Buy price may be too high, if the emergency situation is resolved slowly over time. Ofgem considers that this is an area where interested parties could give further thought to the emergency cash out arrangements including potentially introducing references to other traded gas markets such as relevant NW European hubs or LNG prices at other landing points adjusted as appropriate for transportation costs.

Ofgem notes the concerns that were raised by respondents as to whether it was appropriate to have a dual price cash out mechanism for all emergencies. In particular, shippers were concerned that a distinction should be made between a progressive gas emergency (caused by, for example, bad weather conditions) and an unexpected emergency. Ofgem considers that it is highly unlikely that a gas deficit emergency will not be progressive given the nature of the gas system as in most circumstances it is likely that a GDE will be a consequence of severe weather conditions. We also note that Transco NTS can use linepack and operating margins gas to maintain resilience to the sudden loss of major infrastructure for a number of hours. This makes the sudden declaration of an emergency less likely. There is, therefore, an important difference between the gas and electricity networks. The probability of a GDE occurring rapidly, as a result of, for example, an incident is therefore very low. That said, the treatment of sudden gas emergencies from a commercial viewpoint is still an issue which may merit further consideration over the coming months.

Volume component

In stage one of a gas deficit emergency, Transco NTS has the right to interrupt any site that has elected to have interruptible transportation arrangements. At stage 3, Transco NTS may interrupt offtake by firm end-users. Under the current arrangements, following Transco NTS interruption (of either firm or interruptible load), a shipper's short position will be reduced by the interruption. Therefore, if a shipper thought it was reasonably likely that Emergency Interruption would be instigated, it might prefer to wait for Transco NTS to interrupt its customer once an emergency has been declared and have its imbalance position reduced by Transco NTS, without having to enter into commercial demand side contracts with its customers or going to the market to procure more gas to resolve their imbalance.

The volume component of the modification proposal has the effect of leaving shippers' imbalance positions neutral to the effects of interruption by Transco NTS of their customers. By associating a title trade with an emergency interruption (with the volume of the trade equal to the volume of the interruption – the EIV volume), shippers' imbalance positions are kept constant irrespective of any interruption by Transco NTS. The effect of this should be to provide stronger commercial incentives on shippers to contract for commercial interruption both prior to and in an emergency (and also to take supply side steps to resolve their imbalance position), rather than waiting for Transco NTS to interrupt significant loads.

Ofgem therefore considers that this element of the modification proposal in principle better facilitates the relevant objectives compared to the current arrangements.

However, there are a number of aspects to the volume component of the modification proposal which Ofgem considers could be improved. As above, these improvements broadly fall into two categories.

In relation to **improvements that we consider would be critical complements to the arrangements proposed in the modification**, we believe there are two important areas for improvement:

- The different treatment of firm and interruptible customers; and
- Treatment of disputes in relation to the calculation of the EIV volume.

Differential treatment of firm and interruptible customers

While not clear in the Final Modification Report or in the legal drafting, Ofgem understands from Transco NTS that the modification proposal is intended to result in shippers' imbalance positions being adjusted to take account of interruptions in relation to interruptible supply points only. In other words, in a stage 3 emergency, where Transco NTS interrupted firm loads, shippers' imbalance positions would (as now) be adjusted by the extent of the involuntary interruption.

While Ofgem considers that it may be appropriate, based on the current structure of the transportation interruptible contracts, that interruptible supply points are the first to be curtailed by Transco NTS in the event of an emergency, Ofgem is concerned that shippers whose firm load is curtailed by Transco NTS face different incentives to those with interruptible supply points.

This feature of the modification proposal would appear to discriminate unduly between shippers with customers who have opted to be interruptible and those with customers who are firm. Essentially, shippers with firm customers which they believe are relatively likely to be interrupted by Transco NTS in a stage 3 emergency will continue to be able to rely on Transco NTS's actions to mitigate a short position (and hence avoid exposure to SMP Buy). In contrast, shippers with interruptible customers will have their long or short position kept constant, irrespective of Transco NTS's actions.

This will significantly weaken the incentives for shippers and firm customers to contract *ex ante* for demand response, particularly in relation to large loads which are more likely to be interrupted early in a stage 3 of an emergency. This potentially discriminates against (larger) firm customers, in that they are less likely to be able to capture the potential value associated with demand response which they could provide.

It would not be appropriate for the arrangements to provide for shippers' imbalance volumes to be adjusted to take into account the interruption of all loads on the system as there is little benefit in providing strong incentives for customers below a certain size to contract for commercial interruption services. However, the threshold relating to the application of the EIV trade should not be unduly discriminatory (for example, it could be set with relation to customer volume).

As it stands, the modification proposal arbitrarily draws a distinction between (currently defined) interruptible and firm customers in relation to the incentives which shippers face regarding *ex ante* contracting for demand response. Ofgem considers that this aspect of the proposal is contrary to the efficient and economic operation of the pipeline system.

<u>Treatment of disputes</u>

The volume of interruption of customer load by Transco NTS is not directly measurable – it requires an estimate of the volume which the customer would have offtaken in the absence of the interruption. Under Transco NTS proposal, there would be a methodology by which this volume was estimated, and hence the volume of interruption derived. This methodology relies on the use of volumes specified in the OPNs.

Not all loads will have an OPN. Equally, for gas emergencies of a longer duration, it is possible that the OPN which the shipper submitted (well in advance of the day of delivery) is a relatively poor reflection of the volume which that customer was likely to consume. Since OPNs are submitted at most 21 days in advance of delivery, for gas emergencies with a longer duration, an alternative methodology is required in any case.

Respondents noted that the proposals for deriving EIV volume were not clear. Equally, given that they rely to a significant extent on an estimate of the volume which would have been consumed, in the event of a gas emergency there are likely to be a number of disputes in relation to the estimates on which Transco NTS have based settlement calculations.

Ofgem considers that there would be merit to considering, within the modification proposal, the approach to be taken in relation to the resolution of such disputes, in order that shippers are clear as to how claims will be treated. The absence of such clarity substantially reduces the extent to which the modification facilitates the efficient and economic operation of the pipeline system.

In relation to **improvements which we consider could be considered over the medium term to refine the arrangements proposed**, we note that a number of respondents commented on the fact that the methodology for calculation of the EIV volume is not proposed to be part of the UNC. Particularly as a number of parties (including the DNs) will be providing data to Transco NTS in relation to the derivation of EIV volumes, there may be merit in the inclusion of the methodology in the UNC, in order that it is subject to the code governance procedures. Ofgem consider that this area could be addressed to remove the possibility for some disputes surrounding the calculation of the EIV.

Ofgem's current view against relevant objective (a)

Ofgem considers that overall the decision as to whether Transco NTS's modification proposal would have better facilitated relevant objective (a) is finely balanced. Ofgem has a number of significant concerns regarding the current emergency cash out arrangements – however, there are also components of the modification proposal as drafted which Ofgem considers need to be addressed. If key shortcomings were addressed (particularly those which we have flagged as critical components to the arrangements proposed in the modification), Ofgem considers that the modification would better facilitate relevant objective (a). This view is without prejudice to Ofgem's discretion in considering any future modification proposal.

Standard Special Condition A 11 (b) so far as is consistent with (a), the co-ordinated, efficient and economical operation of (i) the combined pipeline system and/or (ii) the pipe line system of one or more other relevant gas transporters

In its response to the draft modification report, Transco NTS stated that its proposal better facilitated relevant objective (b).

Ofgem notes that the responses received from the DN operators were broadly supportive of the proposal, and two of the operators noted that they believed the implementation costs of the proposal (related to changes to their interruption reporting systems) would not be material. Ofgem notes that one DN operator raised the issue discussed above in relation to the clarity and governance of the methodology used to calculate EIV volume.

Ofgem considers that given its conclusions against relevant objective (a) it is likely that the decision as to whether the proposal would have better facilitated the co-ordinated, efficient and economical operation of the pipeline system is finely balanced.

Standard Special Condition A 11 (d) securing of effective competition between the relevant shippers and suppliers

Price component

Ensuring that costs are appropriately targeted is critical to preventing a distortion of competition. In relation to the cash out arrangements, it is clearly important that those shippers whose portfolios are balanced are not exposed to the costs of Transco NTS undertaking balancing actions for those shippers that are not in balance.

At present, the emergency cash out arrangements represent a form of “collective insurance”. Shippers that are short pay a price for the shortfall which is lower than the true market value of the gas, and conversely, shippers that have surplus gas receive a price below true market value. The arrangements therefore act to insure the shippers that are short of gas at a cost to the shippers who have a surplus.

This “collective insurance” model creates perverse incentives for those shippers that are short of gas. In the run up to an emergency, they face normal cash out arrangements – that is, they face a price for any shortage of gas based on the most expensive of Transco NTS’s trades on any given day. However, once the emergency has been declared, they face a price which has the potential to be significantly lower and does not reflect the cost of balancing the system. This lack of cost targeting has the potential to distort effective competition, as it reduces the incentives for shippers to contract *ex ante* for additional gas or demand side response, and results in cross subsidy between shippers.

During an emergency, the modification would ensure that those shippers that have a short position face a price for their failure to procure sufficient gas to meet the demands of their customers which is reasonably reflective of market conditions. Similarly, shippers who were long gas would face a more market reflective price than is currently the case.

Ofgem therefore considers that Transco NTS's proposal will, in this sense, promote competition by removing the "collective insurance" aspects of the current arrangements. Ofgem therefore considers that the pricing element of the proposal will better facilitate relevant objective (d). We note that Transco NTS also argues that, by targeting cost during an emergency, users will be encouraged to take appropriate actions as a result of which the emergency might be avoided, and that therefore such actions might promote greater and more effective competition between shippers and suppliers.

However, we consider there are aspects of the proposal which, from the viewpoint of facilitating competition, merit further consideration.

Ofgem notes that respondents raised concern in relation to potential information asymmetries in the run up to a gas emergency, and the implications of those information asymmetries for shippers without upstream interests if the incentives to balance in an emergency become significantly sharper. Ofgem considers that, in combination with cash out arrangements which ensure that shippers who are out of balance in an emergency face a cash out liability which reflects the true marginal value of gas, the existence of information asymmetries in relation to the likelihood and timing of any trigger of an emergency could distort competition by giving certain shippers an unfair competitive advantage (for example, they would be able to attempt to source additional gas at an earlier stage, before the emergency became public knowledge and therefore, perhaps before prices have fully adjusted). Ofgem therefore considers that this is an area which would benefit from further development.

Volume component

By providing incentives for shippers and customers to sign *ex ante* commercial demand side response contracts, Ofgem considers that the modification is likely to facilitate effective competition between shippers – it should ensure that there are more competing sources of gas and demand side response in the market in the run up to an emergency (and therefore help to avoid the emergency and maintain the full competitive gas market arrangements in force).

However, Ofgem again considers that there are some aspects of the volume element of the proposal which would merit further consideration in relation to the facilitation of competition. Principally, since the arrangements to associate title trades are intended to only apply to interruption of interruptible customers, competition between shippers with those customers and shippers with predominantly firm customer load is distorted.

Ofgem's current view against relevant objective (d)

As with relevant objective (a), Ofgem considers that the decision as to whether Transco NTS's modification proposal would have better facilitated relevant objective (d) is finely balanced. If key shortcomings were adequately addressed, Ofgem considers that the modification would be likely better to facilitate relevant objective (d). This view is without prejudice to Ofgem's discretion in considering any future modification proposal.

Standard Special Condition A 11 (e) so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure domestic customer supply security standards (within the meaning of paragraph 4 of standard condition 32A (Security of Supply – Domestic Customers) of the standard conditions of Gas Suppliers' licences) are satisfied as respects the availability of gas to their domestic customers

Ofgem notes that Transco NTS's believes the implementation of the proposal will generate reasonable, cost reflective and economic incentives to promote compliance with the domestic customer supply security standards and hence will better facilitate relevant objective (e).

NGT, in its Winter Outlook Report, has stated that supply to domestic customers would be secure even in extreme winter conditions. Equally, the proposal does not contain any provisions which relate specifically to incentives in relation to domestic customer security standards. Therefore Ofgem does not consider that the modification proposal better facilitates relevant objective (e) in particular.

However, insofar as Ofgem considers that there are elements of the modification proposal which better facilitate objective (a) and (d), and which would reduce the chance of the occurrence of a gas emergency and the potential duration of any emergency, then those elements should facilitate improved security of supply for all customers, including domestic load.

Wider statutory duties

Protecting customers

Overall, Ofgem considers that the modification proposal would protect the interests of customers through enhancing the economic and efficient operation of the system as well as promoting competition in the wholesale and retail markets.

A number of customers raised concerns that the proposal would raise gas wholesale prices which would be inconsistent with protecting the interests of customers. Ofgem considers that the proposal will only raise prices to the extent that any market participants were effectively reliant on the artificially low current gas emergency cash out arrangements. Ofgem considers that the current arrangements would smear the costs of an emergency across the industry, rather than target it on those parties that have caused it. By having arrangements in place that target more effectively the costs of an emergency, the likelihood of an emergency arising is reduced. As an emergency would impact adversely on the interests of customers, Ofgem considers that the proposal acts to protect the interests of customers. Furthermore, Ofgem is concerned that the current arrangements have a detrimental effect on competition in both the wholesale and retail markets.

Security of supply

As noted above, Ofgem considers that this proposal reduces the likelihood of an emergency situation arising relative to the current arrangements. Given that an emergency situation will lead to the enforced curtailment of consumption of some customers, any enhancements to the arrangements that increases the probability of avoiding an emergency situation can be considered to facilitate security of supply.

Wider issues

The modification proposal raises a number of further issues in relation to the gas emergency arrangements more generally which would benefit from consideration by interested parties. These are discussed in the sections below.

Prioritisation of interruption

In addition to the issues related to the treatment of interruption within the proposal itself, there are a number of issues relating to the current interruption arrangements more generally. Prior to the approval of UNC modification proposal 013a[18], where a user held an interruptible contract, part or all of its demand could be interrupted for the following reasons:

- constraint management purposes for up to 45 days in any charging year for a standard interruptible supply point;[19]
- for supply/demand balancing if forecast national demand is greater than 85% of the forecast 1 in 20 peak day demand;
- in an emergency; or
- for testing purposes.

Modification proposal 013a removed the ability for Transco NTS to interrupt for supply/demand balancing purposes, thereby reducing the number of reasons for which users can be interrupted. This essentially leaves interruption for transportation purposes as the primary reason for reducing all or part of an interruptible user's demand.

However, Ofgem notes that the direct financial benefits of interruptible status (essentially avoidance of the capacity element of transportation exit charges) remains the same, and that the approach to determining the order in which customers are interrupted in a supply/demand gas emergency remains the same. Ofgem considers that there may be merit in consideration of the extent to which the interruption areas are consistent with the relevant objectives.

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[18] Uniform Network Code modification proposal 013 and 013a "Amendment to Transco's rights to interrupt for supply/demand purposes" (formerly Transco Network Code modification proposals 0740 and 0740a).
[19] TNI supply points may face greater than 45 days interruption.

Keeping the market open

The potential to keep the market open longer during an emergency has been discussed in industry forums and was the subject of network code modification proposal 0635. In its decision letter for network code modification proposal 0635, Ofgem highlighted that it supports the principle of giving the NEC the option to maintain the operation of market arrangements for as long as is considered appropriate in a potential emergency situation, as this may provide commercial incentives for shippers to alleviate an emergency situation. Ofgem continues to hold this view, and considers that retaining commercial incentives could allow the NEC greater flexibility when dealing with an emergency and could encourage the aversion or resolution of emergency situations via commercial mechanisms.

However, Ofgem also considers that it is important to assess whether or not retaining the operation of the market would result in unintended consequences in the market, including limiting additional gas flows during or before an emergency situation and the potential for detrimental interactions with the electricity market. Furthermore, Ofgem considers that if the NEC is to have the ability to retain the OCM, its use of this option must be in accordance with clear criteria to reduce the potential for confusion in the operation of the emergency arrangements. Ofgem considers that this issue merits further consideration by market participants.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject the modification proposal.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Fiona Lewis on 020 7901 7436.

Yours sincerely

Steve Smith
Managing Director, Markets