Shell Gas Direct Limited

Urgent Modification Proposal 0021
Revision of the Emergency Cash out Arrangements

We refer to the above urgent modification proposal raised by National Grid Transco (NGT). It proposes that the current emergency cash-out prices are changed and that the concept of Emergency Interruption Volume (EIV) title trade is introduced.

Shell Gas Direct (SGD) does not support the implementation of this proposal. Shell takes its commitments to ensuring security of the UK gas system very seriously. Like Ofgem and NGT, we are certainly aware of external pressure to ensure that the safety of the system is ensured for this winter and we intend to play our part. However, SGD does not consider that this proposal will promote security of supply. In fact, given its complexity and timing, it is likely that it will serve to undermine confidence in the emergency arrangements, and so negatively affect security of supply. Furthermore, SGD considers that this proposal intervenes with the efficient functioning of the relevant shipping and supply markets and does not further the safe and efficient operation of the pipeline system by NGT. SGD sets out its reasoning for this view below. However, SGD does consider that changes to the formula for calculating the emergency cash out price could be made which could be beneficial for emergency arrangements. We recommend that this current proposal is rejected and consideration given to raising a more focused, beneficial proposal.

Shell Gas Direct is a licensed shipper and supplier to non-domestic consumers, ie both industrial and commercial customers. Throughout this response we refer to "shipper" to cover both the functions of a shipper and of a supplier as relevant.

Winter 2005/06 and development of this proposal

Ofgem recently published NGT's Preliminary Outlook Report for Winter 2005/06. We note these comments in Ofgem's covering letter, "Ofgem agrees with NGT that [emergency gas cash out] is a critical area" and in NGT's report, "NGT supports Ofgem's view that the prevailing emergency cash-out arrangements, where cash-out prices revert to a 30-day average of SAP, may not appropriately incentivise Users to take all actions that might avoid a GDE being triggered." We note that Ofgem and NGT have agreed upon this viewpoint already and assume that this proposal has arisen, at least in part, from discussions between Ofgem and NGT.

While SGD has not attended the most recent discussions on emergency cash-out at the cash out review working group (CORWG), from our review of the notes of these meetings and discussions with those who have attended, this proposal cannot be viewed as a result of industry input. We note that CORWG was largely attended by electricity market representatives whose understandings of the gas market would be insufficient to give robust comments on the discussions. While NGT states that items were "noted" at these meetings, it does mean they were agreed, and we assume that it was often NGT that noted it.

NGT has obtained urgent status for this proposal which Ofgem has granted. By doing this, Ofgem and NGT are suggesting to the market that they consider that there is a

PO Box 219
11 Adam Street
London WC2N 6QA

Registered in England: No. 2405635
Registered Office: Shell Centre
London SE1 7NA
VAT Reg. No. 235 7632 55

Tel: 020 7257 0100

potential for the market to fail this winter. This may be contributing to the sentiment reflected in the forward prices.

Shipper incentives

NGT makes a number of statements within its proposal which provide a misleading view of shipper incentives. The first is whether shippers are already sufficiently incentivised to make arrangements to balance their own portfolios. As NGT is aware, if a shipper is short of gas, it will be exposed to cash out prices. Given the current forward market, this means a shipper who is short in January could find that they are paying in the order of 90p/therm. Given this, we would expect that all shippers would be ensuring that they could take appropriate actions to respond. NGT appears to believe that its intervention is required to ensure that this occurs. SGD has previously provided Ofgem with details of its approach to demand-side response and will continue to work *with* our customers where agreement can be reached.

NGT appears to be assuming that shippers can unilaterally change contractual agreements with customers and/or renegotiate a vast number of contracts at short notice and that this proposal would create this incentives for us to do so.

SGD is willing to respond flexibly as required to contribute to gas security of supply, however it is important not to underestimate the difficulties in rushing to amend contracts so close to the beginning of the winter period. This would be highly inefficient for the industry. We comment further on this below under “Relevant Objectives”.

NGT’s incentives

Shippers balance the gas system while NGT only needs to take limited actions to ensure the system is balanced. When supplies are constrained, NGT may need to take more actions and the price signal sent should ensure that more gas comes on to the system or that demand side responses are triggered. SGD has long argued that as a prudent operator of the system and to ensure its economic, safe and efficient balancing, NGT should contract forward for balancing actions. This would provide the market certainty that many industrial customers would like in order to into demand-side contracts while giving NGT the certainty that the demand will turn down.. This approach was outlined in our modification proposal, 0740/0013, “Amendment to Transco's rights to interrupt for supply / demand purposes”. We understand that Ofgem is minded to accept NGT’s alternative 0740/0013a. The approach being promoted in the current proposal is not compatible with that contained in our proposal. We continue to consider that getting NGT to contract forward, as it does for buy backs etc, to be a more efficient approach to ensuring that it can obtain gas when required. However, this approach may have impacts on NGT’s incentives and raise costs. We see this proposal as an attempt by NGT to avoid these costs and pass risk on to shippers.

In Ofgem’s decision letter on the removal of Top Up, it was noted that Transco supported that proposal and furthermore that the emergency arrangements incorporated the concept that certain sites were “protected by isolation”. This proposal appears to be at odds with the previous decision in that it claims to be about preventing a Stage 1 emergency despite the safety requirement being that the system is kept safe and secure as it is now. We again note that this proposal appears not related to security of supply, but creating conditions to protect itself from criticism should events require interruptible customers to be interrupted in Stage 1 of the procedures. This approach is inconsistent with Ofgem’s decision to implement 0710, “Removal of Top Up”.

Relevant objectives

In this proposal, NGT refers to Relevant Objectives 1.e "the provision of **reasonable** and economic incentives for **relevant Suppliers** to secure that the **domestic customer** supply security standards are satisfied in respects to the availability of gas to their domestic customers. *"* [SGD's emphasis.]

NGT's views here are not unlike that it promoted through proposals 0659 and 0660, which Ofgem rejected. As SGD set out in its response to those proposals 0659 and 0660 the term "relevant supplier" in this context is domestic suppliers. However, these modification proposals do not distinguish between relevant suppliers and others and, as such, could be viewed as discriminatory by imposing risk and change on charges on non-domestic shippers. We consider that domestic shippers are well aware of their obligations to the consumers and assume that they are taking all reasonable steps as prudent suppliers to protect the interests of their consumers. As a transfer of risk, these proposals are clearly not reasonable.

We note that this proposal will have **no** effect on the security of supply to domestic consumers. Even if NGT's premise was considered valid, it would only delay the interruption of interruptible consumers. It would not change the amount of interruptible gas available but rather punish shippers with interruptible consumers in their portfolio, regardless of whether they had supplied domestic consumers or not. Shell has discussed demand side response with consumers, including with firm customers. Taking forward this activity could improve security of supply but implementation of this proposal would take resources away from pursuing these arrangements. It must be noted that many customers <u>choose</u> transportation-only interruption terms. Part of this decision is their perception that risk of interruption for emergency purposes is low. The customer can also <u>choose</u> to have shipper interruption. Our experience is that many on transportation-only terms are not interested in other options: NGT wants to intervene in the customers' decision-making process. All consumers' interests should be considered in developing proposals such as these.

NGT appears to consider that market participants should return to the arrangements which were in place at the time the Network Code was implemented, ie with shippers mimicking the transportation interruption arrangements. This does not mean that there is not demand side response. The market has developed differently from NGT's model in the past few years.. We note that the amount of shipper interruption remains much higher by volume than carried out by the gas transporters, which suggests that shippers are already providing sufficient levels of flexibility to NGT. In addition, the market has responded to high prices by moving to different types of contract. As a recent article in the Heren Report (28 June 2005) set out, the majority of large industrial consumers purchase gas on index-linked contracts such as the Heren Day-ahead price. Demand behaviour is then driven by the prevailing prices with decisions taken by the consumer. The article notes that some companies were already making plans to reduce loads in the coming winter to mitigate the impacts of high prices. The article also suggests that smaller industrials are already being encouraged to look into demand management. This is not "shipper interruption" but still provides the response before an emergency which NGT presumably wants.

We also encouraged to note that Alistair Buchanan's letter of 31st May accompanying the publication of NGT's Winter Outlook Report states in relation to demand side relates it to "large gas customers [taking] a commercial decision on whether to fix the price for their gas this winter or whether to be exposed to the spot price of gas for all or part of their demand." We see NGT's proposal as an unwarranted intervention into the normal development the market and as such is likely to undermine effective competition between shippers and suppliers.

Emergency Cash Out Price Proposal

We can not support NGT's proposals. They promote an asymmetric price which could be considered discriminatory to those shippers who are long on gas. The focus in this proposal is on demand-side but its consideration of the supply-side response is poor and appears to under-value it. The only area where gas COWG participants did consider further amendment to the emergency cash out price is in relation to interconnector flows.

NGT's Winter Outlook Report states that demand side response would be required if supply is lower than expected and/or it is colder than expected. Suspending the market and reverting to command -and-control arrangements which apply to the gas producers and terminal operators appears to be a risk only associated with serious, serial failures and the emergency cash out price would not be apply until Stage 2 of an emergency. These upstream parties would be then under the instruction of the DTI in Stage 2 of an emergency. Shell and other companies with upstream interests have an interest in ensuring that the gas system remains secure and are well aware of the political pressure to ensure a safe system this winter. It is offensive to suggest that there would be any party would have "a financial incentive to withhold gas" and such a statement suggests a poor understanding the financial and reputational incentives such parties have. We would be interested in any evidence that NGT has to support such a statement. This has been discussed repeatedly through workstreams etc and we are disappointed that this has not been understood by NGT and perhaps not by Ofgem. As one example, the significant negative financial impact of "demand destruction" that an emergency could entail needs to be incorporated into any reasonable view of these parties' incentives.

Parties that may need to be incentivised are those who could bring gas through the Interconnector or from Norway. There may be reluctance to make commitments due to the low price that they would receive should the market be suspended. Our reading of this proposal is that they would be under-rewarded in an emergency. If the party had sold gas into the market, ie to Transco through the OCM, then the strike price may be much higher than what they will receive through the prevailing SAP. This makes offering such gas to the market financially risky yet getting this gas into the system is exactly the behaviour to be encouraged.

We recommend that this proposal is rejected but consideration given to another proposal only looking at emergency cash out which ensures that there is a continuing incentive for gas to be imported to the UK in the circumstances envisaged by this proposal.

Emergency Interruption Volume (EIV)

We consider this proposal to be an attempt to take gas from shippers without proper compensation exposing them to new risks associated with contracting with transportation-only consumers. If this were to be implemented and an emergency called, its implementation and use could be subject to challenge. We have noted that NGT has issued various papers setting out in further detail how it would work. We cannot see this proposal as having had sufficient time for industry discussion to be implemented. As we state above, it will have no impact on domestic security of supply and therefore it cannot be related to the relevant objectives. The introduction of complex new arrangements in a tight winter is likely only to add to confusion and will lead to disputes. We find it surprising that “cost targeting” is referred to in these proposals rather than finding the best approach for security of supply. Amongst the areas that require clarity is whether Transco NTS is now planning to take market balancing actions during an emergency despite the fact that the UNC states it will not. SGD has previously asked Ofgem to provide economic analysis to the use of markets and command-and-control actions at the same time. We consider that mixing the two arrangements is inefficient and likely to work to the detriment of consumers. Any excess costs of these proposals will be ultimately borne by consumers.

Urgency

We do not consider that the implementation of this proposal will have any impact on the security of supply for this winter. We are concerned that, as in 2003 with Modification Proposals 0659 and 0660, and in 2004 with Modification Proposal 0710, NGT is raising proposals relatively close to the start of the winter using urgent procedures. Given the extent of debate so far with the proposals in 2003 and 2004, we see no reason why NGT could not have raised these as normal proposals earlier on. The only reason we can see for choosing the urgent route is to reduce the necessary debate about making such extensive changes which should be subject to a full impact assessment by the industry or by Ofgem. We note that NGT was updating legal text as yesterday which only contributes to the view that these proposals are being rushed unnecessarily and are more likely to cause confusion than operational improvement.

While Ofgem appears to have been persuaded that a case could be made that a commercial response will be, and could be, made in the short time available before winter. These views are both incorrect. Instead, we consider that NGT has a continuing interest in reducing its own commercial and reputational risks and is again promoting its preferred approach.

The proposal suggests that it gives “sufficient time for the industry to put in place appropriate arrangements”. It appears NGT grossly underestimates the time, resource and effort that would be necessary for a commercial response, if required, to be made.

Conclusion

Shell Gas Direct does not support these proposals. Shell takes its security of supply responsibilities very seriously. SGD has been working with its customers to develop responses to the high market prices and to ensure that we meet our safety obligations. We do not consider that this proposal will improve security of supply for this winter, and may undermine activities aimed at achieving this. The proposal is potentially discriminatory against those with portfolios without domestic consumers and against those who supply gas on to the system. It acts against effective competition between shippers and relevant suppliers by intervening in market developments aimed at providing security of supply. This proposal should be rejected.

The change to the cash out price within this proposal which would make that price more reflective of market conditions on the day may have positive benefits in bringing in gas through the interconnector. This is worthy of further consideration and we recommend that once this proposal is rejected a new one is raised based on a single emergency cash out price.

Yours sincerely

Tanya Morrison
Regulatory Affairs Manager