

The Joint Office, Relevant Gas
Transporters and other interested
parties

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15 December 2005

Dear Colleague

Uniform Network Code modification proposal 061 "Facilitating further demand-side response in the event that a Gas Balancing Alert is triggered" and Uniform Network Code modification proposal 062 "Introduction of a Gas Balancing Alert"

Ofgem¹ has considered the issues raised in the modification reports in respect of Uniform Network Code (UNC) modification proposal 061 "Facilitating further demand-side response in the event that a Gas Balancing Alert is triggered" and UNC modification proposal 062 "Introduction of a Gas Balancing Alert", and having regard to the principal objective and statutory duties of the Authority², has decided to direct the relevant gas transporters to implement modification proposal 061 and not to implement modification proposal 062.

In summary and for the reasons set out more fully below, Ofgem considers that both modification proposal 061 and modification proposal 062 would better facilitate the achievement of the relevant objectives of the UNC, as set out under Standard Special Condition A11 of the relevant gas transporters' licences as compared with the existing provisions of the UNC. However, Ofgem further considers that modification proposal 061 will better facilitate these objectives as compared with modification proposal 062.

In this letter, Ofgem:

- i. explains the background to the modification proposals;
- ii. summarises the proposals;
- iii. summarises the views of the respondents and the Panel; and
- iv. sets out its views on the proposal and gives reasons for its decisions.

¹ Ofgem is the Office of the Gas and Electricity Markets Authority, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. 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.

Background to the proposal

This section sets out the background to the modification proposals in three key areas, namely:

- ◆ National Grid's (NG) outlook for the gas market in the forthcoming winter;
- ◆ the role of gas shippers in gas balancing;
- ◆ developments in the gas market ahead of this winter.

NG's Winter Outlook Report 2005/06

The purpose of NG's Winter Outlook Report (WOR) is to inform the market of any potential operational issues in relation to the supply and demand of gas and electricity in Great Britain for the winter ahead, particularly in the event of severe weather conditions (1 in 50 severe winter). This year NG conducted a consultation exercise (via the Preliminary WOR published in May 2005³) designed to help the industry and provide feedback for NG to support the production of the WOR 2005/06.⁴

Against supply scenarios developed through consultation with the industry and a single base case comprising assumptions regarding beach gas availability, generation availability, importation flows and gas storage, the WOR 2005/06 outlines (amongst other things) potential requirements for demand side response in the gas market. The report concludes that modest demand side participation would be required in an average winter, and substantial demand side participation would be required in a 1 in 50 winter. In an average winter, NG forecast a requirement of 0.1 bcm of demand side response, all of which is expected to be provided by Combined Cycle Gas Turbines (CCGTs). In a 1 in 50 winter, NG forecast a requirement of 3.7 bcm of demand side response with CCGTs expected to provide 1.8 bcm of demand side response.

The role of gas shippers in gas balancing

NG National Transmission System (NG NTS) has two principal roles associated with keeping the system in balance. NG NTS is responsible for residual gas balancing to the extent that the gas shippers' aggregate inputs to and offtakes from the NTS do not balance. This residual energy balancing role includes the buying and selling of gas in response to sudden unexpected losses of supply or increases in demand within-day (where shippers do not respond). NG NTS is also responsible for undertaking system balancing actions for constraint management purposes on the NTS.

³ 'A Consultation on Winter 2005/06', NG, May 2005 available at:
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/11584_14405b.pdf?wtfrom=/ofgem/whats-new/archive.jsp

⁴ NG published its Final WOR in October 2005 'Winter Outlook Report 2005/06', NG, October 2005 available at:
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12493_214_05.pdf?wtfrom=/ofgem/whats-new/archive.jsp

The UNC provides commercial incentives for gas shippers to balance their inputs to and offtakes from the NTS⁵. These incentives are created by the 'cash out' arrangements that set the price shippers pay or are paid for any imbalances at the end of the day. These arrangements are important for ensuring that the market operates to achieve security of supply by providing incentives for gas producers, suppliers and storage operators to contract to meet their customers' demands and to manage the risk of gas supply failures. When NG NTS in its residual system operator (SO) role undertakes balancing actions it is important that the cost of these actions is reflected in cash out prices so as to provide gas shippers and suppliers with the appropriate incentives to balance their inputs and offtakes from the system.

Developments in the gas market ahead of this winter

In December 2001, Ofgem established a Demand Side Working Group (DSWG) whose purpose was to facilitate further demand side participation in the electricity market. The scope of the DSWG has since been broadened to include gas related issues.

In July 2005, the DSWG, consisting of customers, shippers/suppliers and NG NTS, identified the need to form a further sub-group to consider any "quick wins", i.e. where improvements could be made in respect of facilitating demand side response in the gas market ahead of winter 2005/06. This sub-group identified the following areas for development:

- ◆ **Transparency and quality of information** – discussions resulted in NG NTS further developing its information website and providing a "Daily Summary Report"⁶ which draws together essential information about the gas/supply demand position. These improvements are intended to assist market participants, including customers, in taking commercial based decisions based on timely and accurate information.
- ◆ **Development of a gas equivalent of the electricity Notification of Insufficient System Margin (NISM)** – the group concluded that there was a need for such a notification which could provide an indicator to customers and market participants of the supply/demand position. As a result NG NTS developed the concept of a Gas Balancing Alert (GBA).
- ◆ **NG NTS's role** – the group discussed potential barriers in relation to the ability of NG NTS to accept multi-day bids. Customer representatives commented that some customers required certainty in providing demand side response for periods longer than one day for operational reasons. Some customers wanted the ability to ensure that Over the Counter (OTC) trades could be accepted by NG NTS as some customers have a shipper licence but were not party to the On the Day Commodity Market (OCM). The ability for trades to also be accepted OTC was considered to be an additional route to market which may help facilitate further demand side response. The lack of clarity of

⁵ Although the network code arrangements only apply directly to shippers, these arrangements are relevant for other parties, such as suppliers, through the contractual and market arrangements in place.

⁶ See <http://www.nationalgrid.com/uk/Gas/Data/dsr/>

NG NTS's residual balancing role in respect to whether it could accept such trades was considered to be a barrier.

The further development of the GBA and the discussions surrounding residual balancing role of NG NTS has resulted in modification proposals 061 and 062.

The modification proposals

Modification proposal 061

NG NTS submitted modification proposal 061 "Facilitating further demand-side response in the event that a Gas Balancing Alert is triggered" on 1 November 2005, to which Ofgem granted Urgent status on 2 November 2005.

In summary, the modification proposal seeks to:

- (a) Introduce a Gas Balancing Alert (GBA) to be applied as follows:
 - ◆ NG NTS will issue a GBA during D-1 when the Forecast Total System Demand on a Gas Day is greater than or equal to the anticipated available supplies. The anticipated available supplies will be adjusted to remove the contribution from the various types of storage as the storage stock levels reduce to within two days of the applicable Safety Monitor for each Storage Facility Type; and
 - ◆ NG NTS will issue a GBA 'within-day'⁷ if there is an incident or event notified to NG NTS that it anticipates will result in an end-of-day loss of available supplies of 25 mcm or greater, subsequently resulting in the remaining anticipated available supplies being less than or equal to the Forecast Total System Demand.

Further, the modification proposal seeks to include additional features ("**Additional Features**") designed to reflect the increased likelihood that NG NTS may be required to take additional balancing actions once the market has been notified that a GBA has been triggered. The proposal, therefore, further seeks to:

- (b) Enable NG NTS to accept multiple-day offers on the OCM and/or OTC as Eligible Balancing Actions for a Gas Day or subsequent Gas Days following a GBA; and
- (c) Change the derivation of System Average Price (SAP), the System Marginal Buy (SMP) Buy price and the SMP Sell price following a GBA to incorporate any multiple-day OCM and OTC trades accepted by NG NTS. For each component day of the multi-day trade, the traded volume and price might contribute to the derivation of the cash-out prices based on NG NTS's assessment of the probability that the trade will

⁷ The 'within-day' trigger was originally considered as an additional option within the modification proposals. However, following support for this option during the consultation proposal, the 'within-day' trigger has been included within the legal text for the modification proposals.

be required for that day, which would be determined at the time the relevant trade was undertaken.

Modification proposal 062

NG NTS submitted modification proposal 062 "Introduction of a Gas Balancing Alert" on 1 November 2005, to which Ofgem granted Urgent status on 2 November 2005.

Modification proposal 062 was intended by NG NTS as an alternative to modification proposal 061 providing the day-ahead and within-day GBAs summarised in point (a) of modification proposal 061 above, but excluding the Additional Features designed to address issues of the increased likelihood that NG NTS may be required to take additional balancing actions once a GBA has been triggered, which are summarised in (b) and (c) above.

Respondents' views

This section summarises the principal themes of the respondents' views, it is not intended to provide a comprehensive overview of the responses received.⁸ As all of the features of modification proposal 062 are included in modification proposal 061, we have summarised all respondents' views in respect of each component of the proposals, indicating which are relevant to both modification proposal 061 and modification proposal 062. Accordingly, the views of respondents summarised below in respect of certain components may have been given in response to modification proposal 061, modification proposal 062, or as a joint response to the two modification proposals.

Modification proposal 061

19 responses were received in relation to modification proposal 061. Of these responses, 3 (2 customer representatives and 1 transporter) supported the modification proposal, 4 (1 shipper, 1 customer, 1 transporter and 1 other interested party) offered qualified support and 12 (8 shippers, 1 transporter and 3 other interested parties) were opposed to the modification proposal.

The majority of respondents who did not support implementation of the modification proposal noted that, while they were supportive of the implementation of a GBA, they had significant concerns with regard to the Additional Features aimed at facilitating multi-day trades through the OCM and OTC markets.

Modification proposal 062

20 responses were received in relation to modification proposal 062. Of these responses, 12 respondents (6 shippers, 2 customer representatives, 2 transporters and 2 other interested parties) supported the modification proposal, 6 respondents (3 shippers, 1 transporter, 1 customer and 1

⁸ Respondents views can be found on the Gas Transporters Information Service (formerly known as Nemisys) <https://gtis.gasgovernance.com>

trader), offered qualified support, 1 respondent offered comments and 1 shipper opposed the implementation of the modification proposal.

Gas Balancing Alert

Both Modification proposal 061 and modification proposal 062 would introduce the concept of a GBA within the UNC, therefore the following comments are applicable in respect of both modification proposals.

The majority of respondents were supportive of the implementation of a real time trigger to signal to the market that there is a requirement for demand side response in order to assist in the maintenance of the system supply and demand balance. Respondents generally agreed with the view noted by one respondent that, as a result of the introduction of a GBA, the market should be able to operate more efficiently in the knowledge that a GBA has been issued and, consequently, by taking steps to avoid a National Gas Supply Emergency (NGSE), the system should operate more efficiently through the period of high demand than would be the case without the information.

The Proposer was of the view that the proposed GBA would act as a signal to the market that there was a higher likelihood that demand reduction would be required and would assist the industry in taking appropriate actions to minimise the risk of a NGSE.

Several respondents were concerned that a GBA would only be issued at D-1 following the 14:00 or 02:00 Gas Day forecasts. These respondents were of the view that a GBA should be issued as soon as possible and at any time during the gas day where information is available to NG NTS that may indicate the system is approaching a NGSE.

A number of respondents were concerned that allowing a GBA to remain in place for the duration of a Gas Day regardless of subsequent notifications or changes in forecasts would encourage inefficient behaviour if customers and shippers continued to take actions to respond to a problem that no longer exists. One respondent considered this approach would limit the information available to the market. Another respondent considered that an alternative approach could be for a GBA to persist until it is withdrawn.

One respondent who offered support for the implementation of a GBA noted that they would prefer a process where GBA publication times were fixed in advance or where an Active Notification System (ANS) alert was provided in conjunction with posting a GBA alert on the NG website.

The one respondent opposed to the implementation of a GBA noted that they had doubts whether issuing a GBA at the late stage of day-ahead would facilitate further demand side response. This respondent was of the view that many large consumers would have difficulty in providing demand side response with less than 24 hours' notice.

A further respondent noted that its support for a day-ahead GBA was conditional on clarification of the trigger. This respondent noted it was their understanding that, in practice, NG NTS would also consider other supply side problems that are known at the day-ahead stage when issuing a GBA.

Several respondents who offered both support and qualified support to the introduction of a GBA were of the view that consideration ought to be given to combinations of incidents whose aggregate supply loss was expected to exceed 25mcm, which would then result in the issuing of a GBA.

One respondent requested that the Proposer consider issuing a GBA when supply, excluding LNG and MRS, was less than demand. This respondent considered that if more GBAs were issued, a greater level of demand side response would be encouraged.

A number of respondents were also of the view that if a GBA option were implemented, it would be important to ensure mechanisms were in place to allow NG NTS to explain its decision processes following an event. One respondent requested clarification on how the anticipated available supplies would be determined and what level of detail would be given to the market regarding the GBA methodology. One respondent noted that they offered support for implementation of a GBA on the basis that there would be a continual assessment of the value of a GBA for indicating actual balancing problems and, on the basis that an indication was given, that its introduction would not mitigate the need to improve transparency in the UK market.

One respondent in favour of the introduction of a GBA noted that a potential draw back of the proposal was the method of dissemination of a GBA to interested parties. This respondent considered that the technical solution was to provide for all market participants to receive a GBA simultaneously.

Within-day GBA

In its response to the DMR, the Proposer noted that there was little support for the within-day GBA option at both the UNC Transmission Workstream and the DSWG and considered that unless the majority of responses to the draft modification report supported a within-day GBA, it would not seek to modify the proposals to include this option.

The majority of respondents in favour of implementation of a GBA, as proposed in both modification proposal 061 and modification proposal 062, offered support to a within-day GBA option being included in the modification proposal that they supported. A number of respondents considered it was unlikely that the majority of customers would be able to offer demand side response at the within-day stage, but believed that there was nonetheless no disadvantage in issuing a GBA within-day. One respondent considered that although contribution from demand side would be reduced within-day, there was a strong incentive for interruptible customers to sell back their gas and recover costs ahead of interruption in a potential NGSE. These respondents and a number of others noted that a within-day GBA would correspond to a rapid deterioration of the demand/supply position that all parties should be alerted to as soon as possible.

Another respondent who considered that implementation of a within-day GBA would not be helpful, noted that most customers preferred to turn down gas in an orderly manner as could be provided only by a day-ahead GBA. Another respondent who did not support a within-day GBA option considered within-day supply issues could be signalled through the ANS which would also appear on NG NTS's website.

One respondent who offered qualified support for the introduction of a within-day GBA noted that they would expect within-day discretion to only be exercised by NG NTS in situations where the information underpinning its decision was credible and verifiable.

Another respondent who offered support for the within-day GBA considered that alerting shippers to within-day problems via ANS would amount to discriminatory behaviour because it would be withholding information from that part of the market most able to help the situation.

Several respondents who offered support for the implementation of a GBA noted that they did not support the implementation of a within-day GBA. One respondent noted that, given the problems in defining a within-day trigger and the lack of clarity in terms of whether it would lead to increased demand side response, a GBA should remain a day-ahead tool. This respondent considered that a GBA was an alert and not an instruction, and arrangements should be kept as simple and unambiguous as possible.

Multiple day trades and OTC trades

Only modification proposal 061 would introduce the ability for NG NTS to enter into multi-day trades on the OCM and both single day and multi-day trades with non OCM trading participants on the OTC market. Therefore the following comments are only in respect of modification proposal 061.

The Proposer was of the view that through this provision, modification proposal 061 would ensure that NG NTS was able to utilise all available trading actions to minimize the risk of entering into an NGSE.

The two respondents other than the Proposer who offered support for implementation of modification proposal 061 were supportive of NG NTS securing a route to market for non-OCM trading large end users, allowing them to provide demand side response in circumstances of system stress. One respondent in favour of the proposal considered that by allowing additional balancing actions to be available to NG NTS, market risk would be mitigated and costs kept down. This respondent was of the view that incorporating the proposed changes into the costs of balancing would provide appropriate signals to the market about the availability of gas and the requirements of the system.

Several respondents who opposed implementation of modification proposal 061 were of the view that allowing NG NTS to trade OTC with non-OCM participants would discriminate against OCM trading parties. One respondent noted that demand side offers should be made available to all market participants, as this was the way an efficient market would determine the marginal cost of gas and hence the costs of residual balancing. Another respondent considered that limiting the eligibility of Users who can trade OTC with NG NTS would artificially restrict the offers that could be made available, limiting the opportunity to correct system short falls effectively. A further respondent opposed to the proposal noted that, while it was not clear which companies NG NTS would enter into OTC trades with, limiting trades to non-OCM parties was arbitrary, possibly discriminatory, and likely to be in breach of normal market practice of taking the best price available.

Another respondent against implementation of the proposal was of the view that while gas released by the proposed GBA should be traded on the OTC or otherwise, marginal trades should not have the potential to disproportionately skew market prices established on the OCM.

One respondent considered that demand side response could be facilitated through the existing OCM, while a further respondent noted that allowing NG NTS to undertake OTC trades would undermine the effectiveness and profitability of the OCM. Further, one respondent noted that because OTC trades would effectively be "title" trades, it was not clear that NG NTS would receive the anticipated demand side response.

Cash out methodology

As amendments to the cash out methodology only result from the introduction of multi-day trades and OTC trades the following comments are only in respect of modification proposal 061.

The Proposer was of the view that including OTC contracts in the derivation of cash out prices would further facilitate competition by reflecting the value of all the gas that has been traded to meet residual balancing requirements during times of system stress, thereby ensuring that cash out incentives reflect wider market value. The Proposer was also of the view that setting the price for a multi-day action by assessing the probability of the total system requirement for that gas on subsequent days would ensure that the total cost of the trade was correctly targeted to the days when it was required.

One respondent who offered support for modification proposal 061 was of the view that the proposed methodology for feeding multi-day trades into cash out was not ideal but nonetheless needed to be implemented in its current form, given the time constraints for the winter.

The majority of respondents opposed to implementation of modification proposal 061 expressed concern over the proposed methodology for determining cash-out prices for multi-day OCM trades. One respondent noted that assigning probabilities to prices would allow NG NTS to protect itself by sculpting prices based on the certainty of its demand forecast, effectively passing risk onto shippers. Another respondent was concerned that allowing SMP to potentially be a product of assumptions could potentially give rise to inappropriate price spikes.

One respondent noted that the lack of clarity surrounding the accuracy of NG NTS's daily price forecasting could result in an artificial SMP which was not reflective of the costs of balancing. Another respondent noted that the costs and incentives of balancing would be best determined by actual requirements and not forecast requirements.

One respondent considered that using probabilities in cash out calculations could result in a penal and excessive over recovery of balancing costs. A further respondent noted that Users without real time information may not be able to react sufficiently to prices and may be hit by a penal cash out price which would feed into balancing neutrality and potentially provide windfall gains and losses.

Transparency and information asymmetry

As amendments to the cash out methodology only result from the introduction of multi-day trades and OTC trades the following comments are only in respect of modification proposal 061.

The Proposer considered that the lack of information regarding OTC contracts could lead to some users having asymmetrical access to price information until revised cash out prices were published to the market. However, the Proposer noted it intended to publish price data within an hour of such trades being completed to limit any information asymmetry.

One respondent in favour of modification proposal 061 noted that NG NTS could assist transparency of the proposal by providing explanations of its balancing actions through an Operational Forum following any event. This respondent further noted that potential information asymmetry and lack of real time cash out prices could be remedied following a review of the eligible balancing action mechanism following the winter.

One respondent who offered qualified support for modification proposal 061 was of the view that system actions and resulting prices should be instantly visible to Users. This respondent noted that their support for this proposal was qualified on that basis.

A number of respondents opposed to modification proposal 061 were of the view that the proposed changes, if implemented, would encourage a loss of transparency and increased information asymmetry in the market. One respondent considered that allowing NG NTS to undertake non transparent OTC trades would represent a backward step for UK market operations, also creating the possibility of discrimination between Shippers.

A further respondent was of the view that modification proposal 061 conflicted with Standard Special Condition A 11 (d) of the UNC - securing of effective competition between the relevant shippers and suppliers, by creating an asymmetry of information where some Users would know prices before others, thereby creating an unfair advantage.

The majority of respondents opposed to the implementation of modification proposal 061 considered that the lack of real time cash out price information was a major disadvantage of the proposal. Four of these respondents expressed concern that delays in publishing cash out prices would lead to inefficient and late market signals at a time when clear signals were most needed.

One respondent considered that by encouraging NG NTS to transact in the OTC market without effective and objective tests and immediate price reporting, modification proposal 061 would dismiss the role of the market in managing primary gas balancing. Another respondent considered that real-time information on price and volume was necessary to avoid discrimination.

Materiality

It should be noted that the following comments were raised by respondents in respect of modification proposal 061 only.

The Proposer noted that through discussions at the DSWG it believed there were a number of large gas consumers who would be willing to offer demand side response to the residual balancer when the total system was under stress.

One respondent who offered qualified support for modification proposal 061 noted that the volumes of gas offered from large end users could be significant and could play a major part in preventing a potential emergency. Another respondent offering qualified support for modification proposal 061 considered that, while no information was available on the extent to which additional response would be made available, providing a route to market in principle seemed appropriate.

Six of the twelve respondents opposed to modification proposal 061 expressed concerns regarding the materiality of the proposed changes. One respondent noted that materiality was important and needed to be considered when weighing the costs and benefits of the modification proposal. One respondent did not understand the materiality of the proposal in regards to how many non-trading parties wished to transact. This respondent and another were also unclear what volumes of potential available gas would be released to NG NTS as a result of the changes. Two respondents did not believe that any tangible benefit would be achieved by non-OCM members trading over the counter.

Other issues

One respondent who offered their support for the implementation of modification proposal 061 considered that a full review of the residual balancer role should be undertaken ahead of next winter. In line with this view, another respondent who offered qualified support for the proposal urged NG NTS to initiate a review of its residual balancing role as soon as possible to provide sufficient time for full consideration of the issues and alternatives. A further respondent noted that the proposal raised a number of residual balancing issues which should be considered in a wider review of National Grid's balancing role.

Another respondent who offered qualified support for the modification proposal considered that it would be very helpful if NG NTS could ensure that practical issues associated with the proposals' implementation were fully taken into account. This respondent expressed concern that the proposed changes could introduce significant, additional complexities and difficulties for users in regard to identifying and monitoring associated invoices.

Four respondents who did not support implementation of modification proposal 061 all noted that they had concerns with how the proposed multi-day OTC trades would fit in with the current SO balancing incentives scheme. A respondent also noted that the proposal would encourage NG NTS to undertake more primary gas balancing actions which it could not do as efficiently as market participants.

Panel recommendation

Modification proposal 061

At the Modification Panel meeting held on 1 December 2005, of the 9 voting members present, capable of casting 10 votes, 2 votes were cast in favour of implementing this modification proposal. Therefore, the Panel did not recommend implementation of this modification proposal.

Modification proposal 062

At the Modification Panel meeting held on 1 December 2005, of the 9 voting members present, capable of casting 10 votes, 9 votes were cast in favour of implementing this modification proposal. Therefore, the Panel recommended implementation of this modification proposal.

Ofgem's views

Ofgem considers that it is important that both the supply side and the demand side are able to come to market in the most economic and efficient manner and that the demand side is able to operate in an effective market. In particular, Ofgem considers that this is essential in the interest of ensuring security of supply for this winter, when the supply/demand margin is forecast to be tight. Ofgem also considers that an effective demand side is necessary for price formulation to ensure that the appropriate price signals are provided to the market.

Ofgem has carefully considered the views of respondents and the Panel in relation to both modification proposals 061 and 062. As both modification proposals are seeking to address the same principal concerns and contain a common element, Ofgem has separately considered whether each of these modification proposals would better facilitate achievement of the relevant objectives as set out in Standard Special Condition A11 of the relevant gas transporters' licences. Having regard to its principal objectives and wider statutory duties, Ofgem considers that both modification proposal 061 and modification proposal 062 would better facilitate achievement of the relevant code objectives compared to the existing UNC baseline. However, Ofgem also considers, having regard to the matters set out below, that the Additional Features of modification proposal 061 mean that it would better facilitate achievement of the relevant objectives as compared with modification proposal 062.

Ofgem sets out below the reasons for the Authority's decisions and considers its assessment of the modification proposals against the relevant objectives and the Authority's statutory duties. Ofgem considers that it is appropriate to assess these proposals against relevant objectives (a) and (d).

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

Day-ahead GBA methodology

Both modification proposals 061 and 062 would introduce the concept of a GBA within the UNC. Ofgem agrees with the Proposer and the majority of respondents that this will act as an additional

signal (that is in addition to the price signal available) to the market that there is an increased likelihood that demand reduction will be required and so will assist the industry in taking appropriate actions to minimise the risk of a NGSE. Ofgem considers that this will encourage demand side response hence ensuring that full market participation is initiated before a potential gas deficit emergency, allowing the market to operate more efficiently. Ofgem also notes that some parties are considering using the issuing of a GBA as a trigger within contracts for the requirement for demand side response. Ofgem therefore considers that, by providing this signal to the market and customers more widely, the increased likelihood of demand side participation, which may result from additional contractual requirements, will better facilitate the efficient and economic operation of the gas pipe-line system.

Ofgem understands the concerns of respondents regarding the GBA remaining in place for the duration of the day regardless of the subsequent changes in supply/demand conditions. Ofgem considers that there is a balance between the need for shippers/suppliers to respond to the GBA and the need for customers to have certainty via the GBA signal to provide demand side response. Ofgem considers that the proposed approach, to maintain the GBA signal throughout the day, is likely to better facilitate the efficient and economic operation of the gas pipe-line system by facilitating further demand side response. However, this issue could be considered further going forward to assess whether it would be preferable for a GBA to be withdrawn on a more dynamic basis.

Ofgem notes respondents' views regarding the need for certainty as to when a day-ahead GBA may be issued. From the FMR Ofgem understands that NG NTS would look to make its decision on whether a GBA would be needed once the forecast system demand figures are available. NG NTS has stated that they expected a decision as to whether or not to issue a GBA would occur as soon as possible after the forecast demand figures are provided. Ofgem supports respondents' views that request NG NTS to provide reasons as to why a GBA has been issued after the event. Ofgem considers that the Operational Forum is the suitable forum in which NG NTS can explain the reasons for any such actions.

Within-day GBA methodology

Both modification proposals 061 and 062 allow for a GBA to be notified within-day should the relevant supply/demand conditions be met. Ofgem has considered the views of some respondents that a within-day GBA is not appropriate as it would not give sufficient time for demand side participants to respond and the requirements for how a GBA would be triggered in a within-day situation remain unclear.

While Ofgem recognises that for operational reasons some customers may not be able to respond to within-day GBAs, Ofgem considers that increasing information provision in this respect gives market participants maximum opportunity to respond to such notifications. Unless such triggers are in place, the opportunity for response is much reduced. Ofgem considers that there are some situations in which demand side participants may reduce demand following a within-day GBA notification. For example, Ofgem considers that the issuing of a within-day GBA may send signals to customers on an interruptible contract that the interruptible terms of its contract may be invoked

if demand side response is not forthcoming. In this situation, the party may decide to make an offer to sell its gas back if the interruptible terms of its contract are invoked.

A within-day GBA could also stimulate supply side response in the relevant timescales which could improve the supply/demand situation. Ofgem considers therefore that enabling a GBA to be issued within-day will ensure that information concerning the prevailing supply/demand conditions can be conveyed to the market transparently and that, on this basis, the whole market, including demand side participants, has the full opportunity to respond. Ofgem considers that this will better facilitate the efficient and economic operation of the pipe-line system.

Ofgem therefore considers that, in this respect, modification proposals 061 and 062 will better facilitate the achievement of UNC objective (a) the efficient and economic operation of the pipe-line system.

Ofgem notes that a number of respondents were concerned about how a GBA would be issued and the timing of a GBA being issued. Ofgem considers that it is for NG NTS, as a prudent SO, and market participants to keep under review the GBA methodology, and if appropriate to consider raising a modification proposal to the UNC to amend such methodology going forward.

Multi-day OCM and OTC trades

As outlined within the background section to this letter, some customers indicated during DSWG meetings that although many market participants have the capacity to offer demand side response, the current restrictions on multi-day trades within the UNC restrict them from offering such response. These potential demand side participants have indicated that given their operational requirements they require certainty to turn down and can only do so for a number of days rather than on a daily basis. Under modification proposal 061 participants offering demand side response would be able to offer multi-day trades over a period of up to seven days. Demand side response could also be offered to NG NTS via OTC trades from non-OCM shippers, thereby creating additional routes to market for demand side response. Ofgem therefore agrees with the views of some respondents that by NG NTS being able to accept multi-day trades additional demand side response could be made available to the market. Ofgem considers that this would also therefore increase the ability of the market to operate effectively and could further prevent the system from entering into a NGSE.

Ofgem welcomes the possibility that customers, for whom it would not be viable to offer gas back to the market for a single day, will now be able to consider the option of doing so over a number of days.

Ofgem also agrees with the Proposer and those respondents supporting modification 061 that where participants are contracted with non-OCM shippers, the ability for the SO to access this demand side response by being able to accept OTC trades, would provide the SO with additional means by which to reduce the risk of a NGSE. Ofgem considers that the ability to access demand side response via both the OCM and OTC provides the SO with increased options in its role as residual balancer. It is obviously the case that shippers could contract with the demand side for the provision of this response to balance their inputs and offtakes in the first instance and the SO will

only need to call upon these services in the event that there is a supply/demand imbalance on the system.

Ofgem notes that some respondents consider that restrictions on the parties who can submit OTC trades (i.e. non-OCM parties only as OCM parties are required to participate via the OCM and not OTC) could be considered discriminatory. However, Ofgem considers that as the majority of shippers are OCM participants, the majority of post-GBA demand side offers will be submitted via the OCM, with only a small quantity being delivered via OTC. As mentioned above, Ofgem considers that the ability to undertake OTC trades increases the SO's ability to access demand side response and, in this context, the requirement for OCM shippers to submit offers via the OCM is a practical restriction to facilitate the provision of demand side response for this winter. Ofgem notes the SO has a licence obligation to operate economically and efficiently, which obviously applies to its procurement of demand side response from the OCM and/or OTC. In order to comply with this licence obligation, in procuring demand side response NG NTS will seek to secure it at the best price available. To the extent that the OCM is more liquid and deeper than the OTC market, it is likely that prices on the OCM will be lower and so NG NTS will procure via the OCM in the first instance and will only move to the OTC if options on the OCM are exhausted or OTC options are cheaper. If OTC prices are cheaper, re-pricing of offers on the OCM would be expected. However, if OTC trades continue to provide cheaper options for accessing demand side response, then it would be efficient and economic for NG NTS to take these OTC offers. Given this, Ofgem does not consider that it would be unduly discriminatory for NG NTS to take OTC offers for demand side response given that this could be the most economic and efficient option available. Furthermore, Ofgem notes that it is open for parties not currently registered to sign up to become OCM users if they wish.

It should be noted that Ofgem is not looking to increase the role of the SO as residual balancer. Rather, Ofgem is seeking to ensure that this role is undertaken as efficiently and economically as possible. Ofgem does not consider that the ability to enter into multi-day or OTC trades represents an increased role for the SO but merely a change to NG NTS's historical interpretation of this role which is reflected within the existing systems.

Ofgem therefore considers that, by creating the ability for NG NTS to accept multi-day OCM and OTC trades following a GBA, modification proposal 061 would better facilitate the efficient and economic operation of the pipeline system in comparison to the current situation and therefore will better facilitate achievement of UNC objective (a). As modification proposal 062 does not make provision for multi-day OCM or OTC trades, Ofgem considers that modification proposal 061 would better facilitate the achievement of UNC objective (a) compared to modification proposal 062.

Cash out mechanism

An important element of cash out is that it correctly reflects the cost associated with residual energy balancing in the period to which the actions relate. Currently, trades under the OCM are period specific and hence the costs of trades can be appropriately allocated to the period to which they relate. The inclusion of multi-day trades within the OCM or via OTC contracts means that trades may be taken which cover a number of days. It is therefore possible that on one or more of the days

to which these trades relate it would not have been necessary for the SO to undertake such a trade. NG NTS has therefore proposed that under modification proposal 061 that, for the purpose of determining cash out prices, it would have discretion to allocate the costs of the trades to the specific days in which the trade was needed on the basis of a forecast assessment of the likelihood of the gas being required.

Ofgem recognises that the majority of respondents were generally concerned about the level of discretion that this element of the proposal would afford to NG NTS in respect of the allocation of cash out prices between days. In particular, respondents were concerned that such discretion would depend on the accuracy of NG NTS's daily price forecasting and could result in cash out prices that did not necessarily reflect the costs of energy balancing.

Ofgem considers that it would be inappropriate for bid and offer prices and volumes from multi-day trades to be attributed to days where they were not needed. Ofgem considers that this may result in perverse cash out signals which could affect the incentive on market participants to balance and hence have a detrimental effect on the efficient and economic operation of the pipeline system. Ofgem is therefore of the view that it is appropriate to attribute the costs of multi-day actions to the days on which the trades to which they relate were needed for energy balancing purposes as this would ensure that these costs are appropriately attributed to the days in which the actions were required. Ofgem considers that in order to achieve this it is necessary to give the SO the discretion to allocate these costs based on its judgement, as SO, concerning its requirements for these actions.

Ofgem recognises respondents' concerns about the transparency of the manner in which NG NTS exercises this discretion and considers that, in order to address these concerns, it is essential for the methodology by which NG NTS will exercise this discretion to be displayed openly to market participants. Ofgem considers that the documents produced under NG NTS's licence (e.g. System Management Principles Statement, Procurement Guidelines, System Management Services Adjustment Data Methodology Statement) would provide a sufficient tool to allow market participants to understand the basis on which NG NTS makes its decision to allocate a proportion of such demand side offers to the relevant days. Furthermore, Ofgem is also of the view that the use of ex-post forums, such as the Operational Forum or Customer Forum, provides a useful means by which to give market participants the necessary information regarding such actions as well as a forum at which to question NG NTS's decisions to take them. Ofgem also considers that it is necessary that any such actions taken by NG NTS can be easily audited.

Ofgem also notes that any actions taken by NG NTS should feed through into cash out in a cost reflective manner. Further, Ofgem notes that NG NTS has statutory obligations in respect of not unduly discriminating against parties when carrying out its duties and also in respect to the operation of an economic and efficient pipeline system. Therefore, when using its discretion in allocating any multi-day trades to cash out NG NTS will need to adhere to these requirements.

Ofgem recognises the concerns raised in respect of the lack of real time cash out price information and that delays in publishing cash out prices would lead to late market signals at a time when clear signals were most needed. In this respect, Ofgem notes NG NTS has stated that it intends to publish the effect of such trades on SAP and SMP prices within an hour of such trades being completed. Whilst Ofgem welcomes this commitment from NG NTS, Ofgem considers that an hour should be

the maximum time that elapses prior to publication and considers that this maximum time period should reduce going forward.

Ofgem considers that the reflection in cash-out prices of the costs of multi-day trades following a GBA in the manner described above means that modification proposal 061 would better facilitate the achievement of the efficient and economic operation of the pipeline system (and thus UNC objective (a)) in comparison to both the current situation and modification proposal 062, which does not make provision for multi-day or OTC trades and therefore does not change the existing cash out methodology.

Therefore in summary, in respect of Standard Special Condition A11(a), Ofgem considers that both modification proposals 061 and 062 better facilitate the economic and efficient operation of the pipeline system as compared to the current baseline. However, Ofgem considers that modification 061 better facilitates the achievement of this objective as compared to modification proposal 062.

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

GBAs

As noted above, Ofgem agrees with the majority of respondents that the notification of a GBA should encourage additional demand side response within the gas market, which will in turn encourage competition between shippers and suppliers. Ofgem also considers that if supply contracts incorporate GBAs as a trigger to effect demand side response these will also encourage such competition. Accordingly, Ofgem considers that both proposals will better facilitate the achievement of UNC objective (d).

Multi-day trades

Ofgem considers that the inclusion of multi-day trades within the OCM and allowing multi-day OTC trades following notification of a GBA will both allow additional demand side participation at times of system stress which would not be likely to otherwise be available, thereby creating additional routes to market for demand side response. Ofgem considers that this will better facilitate competition between shippers and suppliers and, as such, these aspects of modification proposal 061 will better facilitate objective (d).

Ofgem notes the views of respondents in respect of the possibility of NG NTS taking actions that may be discriminatory. In this respect, as noted earlier, Ofgem considers that it is not unduly discriminatory for NG NTS to have the ability to access demand side response via the OTC markets as this could represent the most economic and efficient option available to it.

Cash out allocation of costs

It is important that cash out costs are appropriately targeted to prevent distortion of competition between the relevant shippers and suppliers. In relation to the cash out arrangements, it is

important that those shippers whose inputs and offtakes are in imbalance are exposed to the costs that NG NTS incurs in undertaking energy balancing actions for these periods.

As discussed above, the introduction of multi-day trades following the notification of a GBA could potentially result in the SO entering into trades for energy balancing reasons that cover a period beyond which the trade was required. For example, the SO may accept an offer from a participant to reduce demand for a period of three days, but the system may only be short for the first of these days. It would be anti-competitive for a shipper who was not in balance on the second of these days to face the cost of the trade within the imbalance charges for that day. Ofgem therefore considers it is appropriate for the cost of the trade to feed into imbalance charges only in respect of the day(s) on which the trade was needed.

Ofgem therefore considers that the proposed allocation of prices and volumes resulting from multi-day and OTC trades following a GBA means that modification proposal 061 would better facilitate the securing of effective competition between the relevant shippers and suppliers and thus better facilitate the achievement of UNC objective (d) in comparison to the current situation and modification proposal 062, which makes no provision for multi-day or OTC trade and therefore does not alter the existing cash out methodology.

In summary, in respect of Standard Special Condition A11(d), Ofgem considers that both modification proposals 061 and 062 better facilitate effective competition between the relevant shippers and suppliers as compared to the current baseline. However, Ofgem considers that the Additional Features are such that modification proposal 061 is more effective in facilitating the achievement of this objective than modification proposal 062.

Wider statutory duties

Protecting customers

Overall, Ofgem considers that both modification proposals 061 and 062 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.

Security of supply

As noted above, Ofgem considers that both modification proposals 061 and 062 reduce the likelihood of an emergency situation arising relative to the current arrangements.

Given that an emergency situation would lead to the enforced curtailment of some customers' gas, any enhancements to the arrangements that increase the probability of avoiding an emergency situation can be considered to better enhance security of supply.

As argued above, Ofgem considers that the Additional Features of modification proposal 061 provide additional potential for demand side response which may further materially reduce the possibility of a gas deficit emergency situation arising compared to modification proposal 062.

Therefore Ofgem considers that modification proposal 061 is more likely to better facilitate security of supply than modification proposal 062.

Materiality

As indicated in the Notice of Exclusion accompanying this decision, Ofgem considers that it is essential in order to ensure security of supply for this winter that the opportunity for enhanced demand side response provided by modification proposal 061 is implemented as soon as possible. This is supported by information in NG's published WOR, as outlined in the background section to this letter. This WOR stated that, in relation the supply and demand margin, this winter will be significantly tighter than for a number of years and the risk of entering into a NGSE is commensurately higher. The introduction of the GBA will allow for additional demand side response, by providing an appropriate signal to the market and customers of the system needs for additional response and a potential contractual trigger. Modification proposal 061 goes further than modification proposal 062 in respect of enhancing security of supply by proposing Additional Features, namely the ability of NG NTS to accept multi-day offers on the OCM and OTC trades, which provide additional routes to market for demand side response. Ofgem considers that, although the additional volumes of demand side response this creates may not be particularly large in comparison with the total demand, the availability of these additional routes to market could have a material impact on whether or not the system could enter into a NGSE. Whilst the probability of such an event is low, the impact would clearly be high and therefore the importance of preventing such an event, which the Additional Features of modification proposal 061 may further assist, would also be high.

For these reasons, Ofgem considers that both the introduction of the GBA and the Additional Features of modification proposal 061 are likely to have a material impact on security of supply over the coming winter and it is very important that this proposal is implemented as soon as possible.

Wider issues

As noted above, Ofgem is not seeking to increase the role of the SO as residual balancer. Rather, Ofgem is seeking to ensure that this role is undertaken as efficiently and economically as possible. Ofgem does not consider that the ability to enter into multi-day trades represents an increased role for the SO but rather a change to NG NTS's historical interpretation of this role which is reflected within the existing systems. As such, Ofgem is not convinced that allowing multi-day and OTC trades would not be efficient and economic under normal circumstances, i.e. in situations when a GBA has not been triggered. Ofgem therefore considers that it may be appropriate for parties to be able to put forward multi-day bids and offers and enter into OTC contracts under normal circumstances as this would help to ensure that the SO is utilising all available bids and offers when determining which trades to accept, hence potentially reducing the need for a GBA in the first place. Ofgem therefore considers that the notification of a GBA may be an arbitrary trigger for the allowance of such bids and offers.

Ofgem notes respondents' concerns regarding the lack of transparency in relation to NG NTS's allocation of the costs of a multi-day bid. Ofgem considers that it is essential that the methodology by which NG NTS will exercise its discretion in respect of the allocation of multi-day actions into

the cash out price is displayed transparently and assessed on an ex-post basis by market participants. Ofgem also considers that it is necessary that any such actions can be easily audited. Ofgem considers that it may be appropriate, that any such trades and resultant allocation are discussed at the Operational Forum and/or Customer Forums.

Ofgem also notes respondents' concerns in relation to the lack of transparency concerning NG NTS's methodology for allocating the costs of multi-day trades into cash out prices. The implications of the allocation of multi-day trades on cash out prices could be considered in an ad hoc cash out review working group meeting. Ofgem also notes that the issue of transparency has also been discussed in respect of electricity, where it is considered that a specific rules-based mechanism is not appropriate. In order to further the discussions regarding the effect on cash out from the implementation of modification proposal 061 Ofgem will hold a meeting in the New Year.

Ofgem also notes the concerns raised by respondents in respect of the potential for discrimination from OTC trades not necessarily being made available to all parties at the same time. Ofgem notes that NG NTS has stated that it will get this information out to the market within one hour. Ofgem recognises the concerns raised and welcomes NG NTS's one hour limit, which it considers should reduce the extent of such concerns. However, Ofgem recognises the importance of real time information and considers it appropriate that NG NTS should consider this issue further.

Ofgem considers that if market participants wish to discuss these issues further, or to discuss any other enhancements in respect of the operation of a GBA, then there are a number of routes that these issues can be taken forward, including through the DSWG.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject modification proposal 062 and to direct implementation of modification proposal 061.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Simon Bradbury on 020 7901 7249.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Smith', with several horizontal strokes underneath.

Stephen Smith
Managing Director, Markets