

The Joint Office, Relevant Gas
Transporters and other interested
parties

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Dear Colleague

Uniform Network Code modification proposal 067 “Compensation payments to Users whose gas flows are curtailed into the system following instructions received from the NEC”

Ofgem¹ has considered the issues raised in the modification report in respect of modification proposal 067 “Compensation payments to Users whose gas flows are curtailed into the system following instructions received from the NEC” and has decided not to direct the relevant gas transporters to implement modification proposal 067.

Ofgem agrees with the modification panel that modification proposal 067 would not better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11² of the relevant gas transporters’ licences as compared with the existing provisions of the UNC. In this letter, Ofgem explains the background to the modification proposal and gives reasons for its decision.

Background to the proposal

The background associated with this proposal is set out in relation to approved modification 052³. Approved modification 052 provides a form of compensation if storage withdrawal curtailment is undertaken by the NEC which leaves shippers financially neutral in respect of cash out. Although Ofgem considered, on balance, that the proposal would better facilitate the achievement of the relevant objectives of the UNC, in our decision letter we did highlight a number of issues that we considered merited further consideration. It should be noted that Ofgem's decision to approve

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 This Licence Condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547

³ The decision letter for modification proposal 052 can be found on the Gas Transporters Information Service (formerly known as Nemisys) <https://gtis.gasgovernance.com>

modification proposal 052 and the comments included in that decision letter are without prejudice to Ofgem's discretion in considering modification proposal 067.

Modification proposal

Modification proposal 067 "Compensation payments to Users whose gas flows are curtailed into the system following instructions received from the NEC" was raised by Centrica Storage Limited as an urgent proposal on 14 November 2005. Ofgem granted Urgent status to modification proposal 067 on 15 November 2005.

The modification proposal seeks to enable shippers affected by storage withdrawal curtailment directed by the NEC to submit a claim for financial loss suffered as a result of being unable to flow gas from storage. Claims for compensation would be submitted to NG NTS who would then appoint a claims reviewer to assess the case. The claims reviewer would then advise NG NTS as to the amount of compensation that it considered the claimant should receive. Following consultation with the claimant and the Authority, NG NTS would then pay the claimant the amount recommended by the claims reviewer unless the Authority granted approval to a request from NG NTS to pay a different amount.

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.⁴

12 responses were received in relation to modification proposal 067. Of these responses, eight supported the modification proposal and four were opposed. It should be noted that the consultation was conducted prior to the approval of modification proposal 052 and therefore respondents were commenting on this proposal against a different base line from that which now exists⁵.

Respondents supportive of the modification proposal

Perverse incentives to withdraw gas from store

Several respondents, including the proposer considered that the current arrangements⁶, created perverse incentives on storage users to withdraw prematurely their gas from store for fear that it may be stranded later on in the winter. These respondents considered that the modification proposal

⁴ Respondents' views can be found on the Gas Transporters information service (formerly known as Nemisys) <https://gtis.gasgovernance.com>

⁵ Ofgem also notes that further modification proposals (Urgent Modification Proposals 071 and (Alternative) 071a 'User Compensation for NEC Storage Curtailment') have been raised which seek to amend the prevailing arrangements for compensating shippers. Again, it should be noted that the decision on modification proposal 067 has been made on its own merits and is without prejudice to its decision on these, or any future, modification proposals.

⁶ All references to the current arrangements are before the acceptance of UNC modification proposal 052 "Storage Withdrawal Curtailment Trade Arrangements in an Emergency".

would mitigate these perverse incentives by ensuring that users are fully compensated when their gas is 'locked' in store by the NEC. These respondents were also of the view that the modification proposal would reduce the likelihood of an emergency occurring and therefore reduce the subsequent need for the System Operator (SO) to take balancing actions.

One respondent specifically considered that having a compensation regime in place would ensure storage users are incentivised to re-inject gas into store over the winter period, which would result in a more efficient and economic use of the storage facilities.

Undermining the value of storage

The proposer considered that the modification proposal would ensure that storage shippers would continue to value storage services against other substitutable products, providing greater certainty to storage developers to develop storage facilities and products that benefit security of supply in terms of resilience/duration during not only winter but also summer periods. This was supported by a couple of respondents who were of the view that the current arrangements would undermine investment in new storage facilities and the value of storage in the future. These respondents considered that the modification proposal would mitigate these adverse affects on investment.

Discrimination

Several respondents, including the proposer, considered that this modification proposal would remove the discrimination that is currently in place between storage users and other users who use different forms of flexibility. These respondents were of the view that the current arrangements discriminate against storage users by removing the flexibility of using gas in store after a safety monitor breach has occurred. One respondent was of the view that the modification proposal would incentivise shippers to keep their gas in store and enable them to gain compensation for being unable to utilise that storage space when an emergency has been declared.

It was also considered by one respondent that shippers had purchased storage gas to support their portfolios ahead of the winter at prices which did not take into account this extra risk. This respondent expressed concern that if the modification proposal was not implemented, it would leave a balancing risk on shippers throughout the winter period which would discriminate against the shippers that had purchased storage gas. Another respondent supported this argument and considered that shippers whose gas had been 'locked' in store would have to source gas on the day at a far higher cost than the gas in store and therefore should be appropriately compensated for this financial loss.

Detail of the modification proposal

One of the respondents who supported the modification proposal noted its concern as to how the compensation would be calculated under this modification proposal and considered that more information was necessary.

Respondents opposed to the modification proposal

Perverse incentives to withdraw gas from store

One respondent outlined that it did not consider that the current market arrangements incentivised shippers to withdraw gas prematurely from store. This respondent considered that there was an industry benefit in ensuring that adequate storage stocks would be maintained for all non daily metered customers.

Incentives to balance

Two of the respondents considered that this modification proposal would not incentivise shippers to resolve their own imbalances. One respondent stated that the expectation of a level of compensation to be paid at a later date could result in shippers opting not to buy price sensitive sources of gas. This respondent considered that this would have a negative impact on security of supply or result in higher cash out prices as a result of the residual balancer expanding its role and being forced to take a greater volume of trades to cover this gap. The other respondent considered that it could see some merit in allowing compensation arrangements that covered the first day of an emergency, however this respondent considered that if compensation was provided throughout the duration of an emergency over a long period of time it would skew the market. This respondent also considered, that, if this modification proposal was to be implemented it should be time limited to the current winter period.

Timing

Two of the respondents considered that it was an inappropriate time to instigate a significant general change to shipper entitlement to compensation from neutrality. One of these respondents was of the view that an urgent modification raised in isolation was not the appropriate way forward and that this issue should be part of a wider debate on the appropriateness of safety monitors and the NEC Safety Case.

Detail of the modification proposal

Several respondents were of the view that there was insufficient detail contained within the modification proposal to provide a workable solution in time for this winter. One respondent considered that it was not clear whether this modification proposal was just relating to compensation arrangements for storage shippers alone or whether beach shippers who have gas curtailed at entry points were included. Another respondent expressed confusion as to what financial loss meant, as it could include a wide range of things including imbalance charges incurred by the loss of storage supplies, cost of employing extra resources to cover the loss of storage supplies etc.

Another respondent expressed the view that the modification proposal failed to restrict the basis on which claims could be made. The respondent drew a parallel with the beach supplies and stated that compensation at the beach is limited to financial losses they may have incurred having been instructed to deliver gas to the system at System Average Price (SAP). This respondent also

considered that the modification proposal failed to make reference to constrained storage, where it would be inappropriate to compensate storage users for curtailment, if they were subject to withdrawal constraints under their contractual terms.

Another respondent considered that this process would require the identification of a group of suitable persons that may act as a claims reviewer. This respondent was also of the view that procedural documents would need to be prepared and agreed in order that all parties would be clear on the process, outcome and scope.

Funding the compensation arrangements

One respondent considered that it was inappropriate for costs incurred by the SO to be smeared across all users. This respondent considered that it would be more appropriate for the NEC to have these SO actions included in an incentive scheme.

Panel recommendation

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 modification proposal 067. Therefore, the Panel did not recommend the implementation of this modification proposal⁷.

Ofgem's view

Having considered the views of respondents and the Panel, Ofgem considers that modification proposal 067 would not better facilitate achievement of the relevant code objectives compared to the existing provisions of the UNC⁸. The reasons for Ofgem's decision in relation to modification proposal 067 are outlined in the sections below. Ofgem considers that it is appropriate to assess this proposal 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

As set out in relation to modification proposal 052, Ofgem agrees with those respondents that considered that there should be appropriate arrangements for compensating shippers who have flows from storage curtailed by the NEC to ensure that storage continues to be valued as a flexible source of gas. Ofgem considers that this will ensure the economic and efficient operation of the system in the short and long run.

However, Ofgem shares the concerns of several respondents surrounding the arrangements set out in modification proposal 067. The benefit of a formulaic approach to storage curtailment compensation, such as that set out in modification proposal 052, is that those users with gas in

⁷ A Panel recommendation requires a majority vote from voting members at a quorate meeting of the Modification Panel.

⁸ It should be noted that Ofgem has arrived at its decision against the current baseline, which has changed since the consultation for this modification proposal due to the implementation of UNC modification proposal 052.

store, as well as those that may be affected as a consequence of claims through neutrality, will have a good ex-ante understanding of the likely levels of such compensation. The issue with such an approach is that it will be very difficult to ensure that a formula creates arrangements which are appropriate for every storage user. Modification proposal 067 addresses the concern that individual party's claims to compensation may vary by allowing each party's claims to be considered on an individual basis, but in addressing this uncertainty it does give rise to potential risks and costs. The risks of this approach include that parties seeking to receive compensation following storage curtailment, will not have certainty as to the likely level of compensation that they will receive. This uncertainty could affect the incentives on shippers relating to the use of gas in store.

In respect of costs, the administration of the compensation scheme will be spread across all users, there is the potential for trivial claims, or claims lacking merit, to be raised which would increase these costs unnecessarily. As drafted, the modification proposal does not include sufficient detail to allow effective assessment of the practical operation and therefore also of the benefits of this proposal as against the costs and risks involved.

Ofgem also agrees with a number of respondents who stated that the proposed compensation arrangements lack certainty in terms of, for example, the types of costs for which a claim could be submitted and the basis upon which the claims reviewer would make its assessment of these costs. Ofgem considers that this lack of clarity, and the potential for uncertainty that it creates, makes it difficult to validate the opinion that the compensation arrangements proposed under modification proposal 067 would reduce any perverse incentives for shippers to withdraw gas from storage or influence long term investment decisions by storage facility owners and/ or operators.

Ofgem therefore considers that the case has not been made that the modification proposal will better facilitate the achievement of relevant objective (a).

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

Since the approval of proposal 052 compensation arrangements do exist, in that shippers are held neutral to cash out charges following a storage curtailment. In order to avoid discrimination against storage users who have flows from storage curtailed by the NEC, as set out in our decision regarding modification proposal 052, Ofgem considers that there should be appropriate arrangements for compensating these shippers for other losses incurred when storage curtailment is invoked.

As set out above, Ofgem considers that there may be advantages as well as risks and costs which arise from the adoption of an individual assessment approach to storage compensation in the event of NEC invoked storage curtailment consistent with the arrangements set out in modification proposal 067. A claims process designed to give flexibility could ensure that each user is appropriately compensated. However, Ofgem notes a number of respondents' concerns surrounding the proposed cost recovery mechanism under this proposal and the potential distortion on competition that this may cause. Ofgem has not been able to fully assess the benefits of the proposed approach versus the risks given the lack of information provided concerning the proposed claims process in the modification proposal.

Therefore, on the basis of the information provided, Ofgem has been unable to demonstrate that modification proposal 067 better facilitates the achievement of relevant objective (d).

Summary

Therefore, for the reasons outlined above, Ofgem does not consider that it has been demonstrated that modification proposal 067 would better facilitate the achievement of the relevant objectives.

Wider issues⁹

Ofgem considers that there are several shortcomings in relation to the Safety Monitor arrangements. To overcome these issues, Ofgem considers, as outlined in the decision letter for modification proposal 035, that the arrangements would benefit from a more fundamental review ahead of next winter. Ofgem yesterday highlighted that it will chair a meeting with market participants and interested parties in relation to the gas safety reserve requirements on 16 January 2006. Further details in relation to this meeting will follow shortly.

In its decision letter for modification proposal 052, Ofgem outlined its views on the aspects of the Safety Monitor arrangements which would benefit from further urgent consideration by interested parties. Ofgem continues to consider that these issues should be progressed urgently by market participants, including NG NTS.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject modification proposal 067.

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 or Fiona Lewis on 020 7901 7436.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sonia Brown', written in a cursive style.

Sonia Brown
Director, Wholesale Markets

⁹ The provision of views in this section does not fetter the Authority's discretion in relation to any future modification proposals on the issues discussed.