Modification proposal:	Uniform Network Code (UNC) Modification Proposals 0149/0149A: Gas Emergency Cash-out Arrangements: Keeping the On-the-day Commodity Market open during a Gas Deficit Emergency		
Decision:	The Authority[1] has decided to reject Proposal 0149 and accept Proposal 0149A		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	19 October 2007	Implementation Date:	To be notified by the Joint Office

Background to the modification proposal

The resilience of the gas and electricity systems in response to sudden and extreme events has been discussed within the industry for some time. These discussions led to some significant changes to the gas emergency cash-out arrangements in advance of winter 2005/06. However, in an open letter to the industry on 9 November 2006, Ofgem outlined its remaining concerns in three areas: emergency gas cash-out arrangements, credit arrangements, and emergency contact information. We asked the industry to address these issues as a matter of urgency. We subsequently held a series of workshops on options for gas emergency cash-out arrangements. UNC Modification Proposal 0149 and UNC Modification Proposal 0149A followed.

Under the current emergency arrangements[2] National Grid NTS (NG) is responsible for declaring an emergency and relinquishing the responsibility for system balancing to the National Emergency Coordinator (NEC)[3]. Five stages of alert may be declared although not necessarily in sequence.

During Stage 1 of a National Gas Supply (Gas Deficit) Emergency NG will indicate a potential gas emergency and maximise use of linepack, storage and interruption. Under Stage 1 normal cash-out arrangements apply[4]. At Stage 2 (or beyond) of a Gas Deficit Emergency the OCM (On-the-day Commodity Market) is suspended. At this point the NEC takes responsibility for physically balancing the system, and NG can no longer take market balancing actions. Emergency cash-out prices are established, which under the current arrangements, are 'frozen' at the prices prevailing at the point of entry into Stage 2 (or beyond) of the emergency.

Until recent years when the supply situation for the GB market changed significantly, the powers granted to the NEC to instruct Users to maximise inflows at entry points[5], and to co-ordinate demand reduction, load shedding and the use of domestic storage, should have been effective in doing everything possible to reduce the severity and duration of an emergency. However, as the UK is becoming more dependent on imported gas, from Norway, continental Europe via inter-connectors and the global Liquefied Natural Gas (LNG) market via new import facilities (collectively referred to as "non-UKCS supplies" in this letter), those command and control powers will become less effective in co-

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] See section Q of the UNC
[3] The NEC Safety Case, in conjunction with the Gas Safety (Management) Regulations (GS(M)R) (1996), details the arrangements for co-ordinating the actions to be taken to prevent a supply emergency occurring or continuing.
[4] See section F of the UNC
[5] In addition, the Department of Business, Enterprise and Regulatory Reform has the powers to instruct offshore producers to maximise production.

ordinating a Gas Deficit Emergency. Under the UNC, NG (under the NEC) cannot itself buy gas including non-UKCS supplies to help balance the system, and whilst it can require Users to maximise inflows of contracted gas it cannot ultimately force them to buy additional gas in the continental or global LNG markets. Hence, it is increasingly important that in an emergency situation the rules continue to create appropriate incentives to encourage Users to maximise their own purchases of non-UKCS supplies to flow into the GB market. If the rules are not appropriate, this could lead to gas being diverted away from the UK to other markets and this could increase the severity or prolong the duration of the emergency.

As we have explained previously, for example in our decision letters on Modification Proposals 021[6] and 042/044[7], the emergency arrangements play an important part in maintaining the commercial incentives on gas producers, suppliers, importers and storage operators to maintain security of supply. Inappropriate emergency arrangements, through weakening the strong financial incentives on all Users to balance their supply and demand positions at all time could reduce security of supply and increase the probability of an emergency occurring.

The important role that the emergency gas cash-out arrangements have in creating incentives for market participants to take actions to bring the gas supply and demand into balance was recognised by the Government in the recent Energy White Paper[8]. Ofgem also places considerable importance on this issue. Over several years we have expressed the concern, shared by a number of industry participants, that the current arrangements may not be providing sufficient incentive for parties to flow non-UKCS supplies into the GB market under emergency conditions, possibly leading to an increased severity and/or duration of the emergency.

UNC Modification Proposal 0149

Proposal 0149 was raised by NG with the intent of:

1) opening the OCM to Users during a Stage 2 (and beyond) Gas Deficit Emergency; and
2) setting a market reflective and dynamic cash-out price during the emergency.

It is proposed that upon declaration of a Stage 2 (or beyond) Gas Deficit Emergency, Users, with the exception of NG, will retain the ability to trade on the OCM. NG will suspend its use of the OCM, in line with the transition to physical balancing of the supply and demand position via the NEC. Trades carried out between Users in this manner shall be incorporated in the derivation of the “relevant price”. The relevant price will be calculated for each Day during a Gas Deficit Emergency (Stage 2 and beyond) as follows:

- *positive* imbalances will be cashed out at the *volume weighted average* of all the Market Offer Prices taken for that day;
- *negative* imbalances, will be cashed out at the *highest* Market Offer Price taken for that day.

On days during the Gas Deficit Emergency (Stage 2 and beyond) where no eligible trades are made on the OCM, the relevant prices for that Day will default to the previous day’s relevant prices. The same pricing methodology applies for Day 1 of an emergency.

[6] Uniform Network Code modification proposal 021 'Revision of the Emergency Cash-Out Arrangements' 29/07/2005
[7] Uniform Network Code modification proposal 042 and 044 16/09/2005
[8] Energy White Paper: meeting the energy challenge, DTI, May 2007,URN No: 07/1006

Although alternative pricing mechanisms have been suggested, the proposer continues to consider a marginal pricing system to be most appropriate.

The proposer considers that this modification would better facilitate the achievement of Relevant Objectives (a), (d) and (e) of Standard Special Condition A11(1) of the Gas Transporters Licence for the reasons set out below.

Objective (a) - the efficient and economic operation of the pipe-line system

The proposer believes that by enabling another route to market to be available for non-UKCS gas supplies to enter the GB system, Users may be able to provide greater cooperation with the NEC to reduce the depth and/or duration of a Gas Deficit Emergency.

Objective (d) - the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers

The proposer believes that the extension of the OCM route to market will facilitate this objective by giving Users a greater opportunity to trade out their imbalances, and by setting relevant prices based on Users' trades, which will result in more market reflective and dynamic incentives being set during the emergency. Both of these should lead to improved cost targeting, encouraging Users to take appropriate actions through which an emergency might be avoided or its extent and duration lessened.

Objective (e) - so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

The proposer believes that the implementation of this proposal might facilitate the achievement of this objective by providing strong economic signals throughout a Gas Deficit Emergency.

UNC Modification Proposal 0149A

The alternative proposal, raised by EON UK, is also being brought forward with the intent of opening the OCM to Users during a Stage 2 (and beyond) Gas Deficit Emergency. Under this alternative proposal the relevant prices shall continue to be derived as currently, frozen at the prevailing prices on the Day on which the Gas Deficit Emergency (Stage 2 and beyond) started.

The proposer argues that the invoking of Emergency Procedures is an implicit acceptance that normal market conditions, and the rules that apply under such conditions, can no longer apply. The proposer makes reference to the fact that it is deemed necessary for NG to act beyond its residual role in an emergency (e.g. by interrupting firm customers for energy balancing purposes).

The proposer argues that Users will not necessarily be able to respond to so called 'dynamic' cash-out prices in the same way as they would under normal market conditions, arguing that financial incentives to balance only work if Users have the ability to respond. A User may be faced with a substantial 'short' position as a result of a major terminal failure which in turn resulted in the declaration of a Gas Deficit Emergency. The proposer argues that such a party has no incentive to seek to obtain price sensitive 'merchant' gas from outside the UK jurisdiction, as this is likely to set a higher cash-out price and exacerbate its already significant financial exposure.

The proposer considers that this modification would better facilitate the achievement of Relevant Objectives (a) and (d) of Standard Special Condition A11(1) of the Gas Transporters Licence for the reasons set out below.

Objective (a) - the efficient and economic operation of the pipe-line system

The proposer considers that it is important to keep the OCM open as another route to market for Users, and that the frozen cash-out prices are likely to be high and hence provide sufficient incentive to purchase non-UKCS supplies.

Objective (d) - the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers

The proposer argues that the continuation of the 'frozen' emergency cash-out price will ensure that market participants will have greater certainty with respect to imbalance cash-out exposures, enabling them to focus on their duty to cooperate with the NEC. Additionally, by avoiding the imposition of dynamic cash-out prices, this proposal will enable more parties to stay in business than might otherwise be the case, facilitating greater competition in shipping and supply.

Implementation

In the case of one of these proposals being implemented, APX would require 14 days for minor system changes for 0149, and no changes for 0149A.

UNC Panel recommendation[9]

At the Modification Panel meeting held on 19 July 2007, of the 10 Voting Members present, capable of casting 10 votes, only 3 votes were cast in favour of implementing Modification Proposal 0149. Therefore, the Panel did not recommend implementation of Modification Proposal 0149. At the same meeting, 6 votes were cast in favour of implementing Alternative Proposal 0149A. Therefore the Panel recommended implementation of Alternative Proposal 0149A.

The Panel then proceeded to vote on which of the two proposals would be expected to better facilitate achievement of the Relevant Objectives as set out in Standard Special Condition A11(1) of the Gas Transporters Licence. Of the 10 Voting Members present, capable of casting 10 votes, 3 votes were cast in favour of implementing Proposal 0149 in preference to Alternative Proposal 0149A, and 5 votes were cast in favour of implementing the Alternative Proposal 0149A in preference to Proposal 0149. Therefore, the Panel determined that, of the two proposals, Alternative Proposal 0149A would better facilitate the achievement of the Relevant Objectives.

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[9] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

The Authority's decision

The Authority has considered the issues raised by both proposals and the Final Modification Report (FMR) dated 28 August 2007. The Authority has considered and taken into account the representations to the Joint Office's (JO) consultation on the proposals, and has decided to accept Alternative Proposal 0149A as this better facilitates the Relevant Objectives and therefore directs that it be implemented.

The Authority is disappointed with the lack of information and analysis contained in the FMR relating to Proposal 0149. Given this lack of information and analysis, it has been unable to conclude whether implementation of Proposal 0149 will better facilitate the achievement of the Relevant Objectives. The Authority has therefore not concluded that implementation of Proposal 0149 will better facilitate the achievement of the Relevant Objectives, and therefore does not direct that it be implemented.

Reasons for the Authority's decision

As set out above, Ofgem considers that to protect customers' interests, it is important that there are appropriate gas emergency arrangements in place. The change from being largely self sufficient for gas supply to becoming more reliant on imported sources of supply has resulted in the need to review closely these arrangements. Overall, the arrangements must ensure that during a gas emergency importers of non-UKCS gas have an appropriate continued incentive to supply gas. A cash-out price that is either set too high would also be detrimental to customers. We therefore in principle, support the suggestion that a more dynamic cash-out price even in emergency situations is appropriate.

However, we do not believe that the FMR has properly identified and analysed the issues surrounding the impact of cash-out prices on the gas market under an emergency, and it was deficient in explaining, exploring and analysing the arguments and in explaining the basis on which the Modification Panel's conclusions were reached.

Despite the lack of supporting analysis, we consider that on the balance of judgement and in principle both proposals further the facilitation of Relevant Objective (a) of Standard Special Condition A11(1) of the Gas Transporters Licence on the basis that they provide for an alternative route to market for non-UKCS supplies. Nevertheless, we do not believe that we have sufficient information to reasonably conclude that Proposal 0149 would better facilitate the achievement of Relevant Objectives (d) and (e). We are concerned that the possibility of unintended consequences associated with Proposal 0149 has not been fully explored. We believe that Alternative Proposal 0149A marginally facilitates Relevant Objective (d), and is neutral as regards the better facilitation of Relevant Objective (e).

For these reasons, and in spite of the importance that we attach to this issue and our support in principle for dynamic cash-out prices under an emergency, we have decided to accept Alternative Proposal 0149A and reject Proposal 0149.

However, we remain very concerned that the frozen cash-out prices in a Gas Deficit Emergency under the current arrangements and under Alternative Proposal 0149A may not be sufficient to provide the right commercial incentives on Users to take all reasonable measures to cover their positions in the event of an emergency. We think that Users should continue to have strong financial incentives to buy gas and/or extend their ability to curtail demand under emergency conditions for example through entering into new contractual arrangements with customers not already on interruptible contracts to cut demand. The emergency cash out arrangements will also affect the incentives on companies to take steps to insure against the effect on their business of a sudden loss of supply such as a major infrastructure failure. This would reduce the likelihood of an emergency being declared in the first place.

Ofgem does not accept the argument that market arrangements are not relevant or appropriate once an emergency is called. This is for two reasons. First, the emergency arrangements will affect the likelihood of an emergency being declared. For example, a large shipper who was short of gas and faced a significant cost in bringing its portfolio into balance, through striking very expensive short term demand side contracts or buying very high priced spot gas in continental Europe, might not take these expensive actions if it judged that failing to do so would lead to an emergency being declared and much lower financial exposure under the emergency cash-out arrangements. Second, the emergency arrangements will influence Users' assessment of risk and financial exposure and hence the arrangements they make to cover their positions against a loss of supply to their portfolio, which also affects the likelihood of an emergency occurring.

Should an emergency occur, we believe that frozen cash-out prices are unlikely to be appropriate. They may, under certain circumstances, be too low so that non-UKCS supplies will not be attracted to GB. At the extreme, it is possible to envisage situations where low cash-out prices could even create commercial incentives for Users to reduce imports and sell gas in to higher-priced continental markets and take the cash-out exposure in the GB market. In other circumstances "frozen" cash-out prices could be too high so that Users, and ultimately customers, are paying too much for their gas and any imbalances.

To illustrate this, we have set out three plausible scenarios that could give rise to cash-out prices under the current arrangements and under Alternative Proposal 0149A, that are either too high or too low and that could, as a result, increase the impact or duration of an emergency on Users and customers.

- An emergency called after, for example, two sudden terminal or infrastructure failures (for example a fire at the Rough storage facility combined with the sudden loss of one of the interconnectors on a cold winter's day). If this situation developed very rapidly the market may have little time to respond before the emergency is declared with the result that the cash-out prices could be frozen at a relatively low level. The price signal may be too low for Users to seek to buy more gas from non-UKCS sources or to strike contracts with customers to reduce demand. The result in an extended emergency and large numbers of customers being disconnected from the network.
- A similar situation to the above but where the market had started to respond before the emergency was declared, with cash-out prices being frozen at a relatively high level. However, further shocks in continental Europe (such as very high demand or the loss of a key import pipeline) could lead to European price levels moving above frozen GB prices. This could lead to reductions in flows through all import facilities increasing the impact and duration of the emergency.
- An emergency declared after a major outage at a large terminal or storage facility such as occurred in Victoria, Australia. The emergency is severe enough that a number of customers have to be isolated from the system. The supply/demand position then improves (for example the weather improves and demand reduces significantly) but the emergency arrangements cannot be suspended until customers have been safely re-connected. Emergency cash-out prices would continue to apply but could be much higher than required as they would still reflect the supply/demand balance at the point the emergency was declared.

In light of these risks, we still think that the gas emergency arrangements need to be revised further and would encourage the industry to complete the necessary analysis relating to a more dynamic cash-out price as soon as is practicable.

Below we give our assessment of each modification proposal against the Relevant Objectives as set out in Standard Special Condition A11(1) of the Gas Transporters Licence.

UNC Modification Proposal 0149

Objective (a) - the efficient and economic operation of the pipe-line system

Some respondents suggested that Proposal 0149 would aid the economic and efficient operation of the system by providing an additional route to market for non-UKCS supplies during an emergency situation. We consider that keeping the OCM open would at worst result in no change from the current arrangements, and by providing the additional route to market could result in more non-UKCS supplies flowing into the GB market under an emergency.

We therefore conclude that Proposal 0149 would better facilitate this objective.

Objective (d) - the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers

Some respondents argued that Proposal 0149 would facilitate this objective since, by keeping the OCM open, Users would have a greater opportunity to trade out their imbalances, thereby potentially lessening the extent and duration of an emergency. Furthermore, by providing dynamic price signals we agree with some respondents that Proposal 0149 may better facilitate objective (d) than Alternative Proposal 149A.

However, we consider that further analysis is required in this area. In particular, we would like to understand how cash-out prices might evolve in an emergency under Proposal 0149 and what might be the impact on flows across inter-connectors. We would also like to understand the extent to which the dynamic cash-out prices would attract more non-UKCS supplies in to the GB market. To answer this, we believe that Proposal 0149 should be assessed against a number of different plausible scenarios such as the examples we have outlined in this letter.

We note the concerns of some respondents with Proposal 0149 surrounding the possibility of cash-out prices spiralling when no longer based on the actions of the System Operator. We believe that this warrants further investigation. We think that analysis needs to be undertaken whether a marginal price is appropriate in these circumstances. This analysis needs to explore the risk of small volume but very high priced actions setting the cash-out price.

We also think that analysis/questions need to be considered about how the demand side feeds into cash-out in emergency situations. Under the normal cash-out arrangements, it is possible for the demand side to set prices through signalling the price at which it is willing to curtail all or part of its load. This is not possible under the current rules for a Gas Deficit Emergency since the NEC will shed load on the demand side outside of any market mechanism. We therefore consider that further analysis is required surrounding the costs of curtailment and the risk of cash-out prices exceeding these costs under Proposal 0149[10].

Some respondents believed that implementation of Proposal 0149 would provide potential for Users to "game" by setting high SMP Buy cash-out prices to their advantage. This could lead to other Users being commercially disadvantaged. One respondent suggested that such a risk would be mitigated by robust regulatory presence, but several others felt that instances of gaming would be difficult to identify or prove. Ofgem has powers under the Competition Act[11] to investigate and take action against anti-competitive conduct. We think that the current focus of attention should be on putting in place arrangements that provide appropriate commercial incentives under emergency arrangements on the assumption that Users do not behave in this way and seek to game the rules, in the knowledge that Ofgem has the necessary powers to intervene, if necessary.

Similarly, some respondents noted that the possibility of very high cash-out prices under Proposal 0149 could lead to financial difficulties for some players. Conversely, some respondents considered that the more dynamic pricing of Proposal 0149 might reduce exposures in other circumstances when the market is returning to normality and prices might fall below the level frozen at the start of the emergency.

Users have to assess their risk and financial exposure to a range of events (for example loss of supplies, credit risk and exposure, adverse movements in market prices) as part of their normal commercial operations to avoid the risk of getting into financial difficulty. This standard process of risk management is important to maintain the appropriate incentives on Users in a competitive market. In our decision letter on Modifications 042/044, we highlighted our concerns that the emergency cash-out arrangements were effectively acting as a form of 'collective insurance'.

Whilst Modification 044 has gone some way in addressing this issue by setting the SMP Buy price to the cost of the NG's marginal action prior to the emergency on the day rather than the thirty day average rolling System Average Price (SAP), we still have concerns in this area. Where certain Users are not making sufficient arrangements other Users and customers bear the costs of their lack of insurance. This is for two reasons. First, the costs of compensating Users who, having followed the NEC's instructions, were long but only received a relatively low frozen cash-out price (SMP Sell[12]) for their gas under the claims procedure would be channelled into balancing neutrality and smeared to all Users[13]. Second, the role of the NEC would be extended probably leading to greater interruption of firm customers (including those of suppliers who were in balance or long.) Hence, we believe that Users should be exposed to the costs of their imbalances during an emergency and that dynamic cash-out pricing during an emergency would be a way of achieving this.

However, due to the risk of unintended consequences and in the absence of further analysis, we are unable to conclude that implementation of Proposal 0149 would better facilitate the achievement of this objective.

[10] The Energy Curtailment Trade Price which is paid to Users for volumes of firm load shed is based on the SAP over the preceding 30 days. Whilst this might act as a reference for the curtailment cost, it is unlikely that this reflects the true cost to customers of firm load shedding.
[11] Any person who has suffered loss or damage as a result of anti-competitive behaviour is also able to raise a claim under the Competition Act.
[12] Under a Gas Deficit Emergency, SMP Sell is frozen at the prevailing System Average Price at the point that the emergency is declared.
[13] Under dynamic cash-out pricing the costs of the shortfalls would be targeted directly at out of balance Users.

Objective (e) - so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

For the reasons set out above in relation to Objective (d), the implementation of Proposal 0149 may further objective (e) by providing greater economic incentives for suppliers to meet the supply security standards. This should reduce the likelihood of emergencies occurring in the first place. However, if expectations of emergency cash-out prices are too high, suppliers may over-insure and pass on the additional costs to customers.

Further analysis is required on how forward contracting strategies might change in response to anticipation of dynamic cash-out prices under an emergency.

We are therefore unable to conclude that implementation of Proposal 0149 would better facilitate this objective, and believe that further analysis is required.

UNC Modification Alternative Proposal 0149A

Objective (a) - the efficient and economic operation of the pipe-line system

Some respondents suggested that Alternative Proposal 0149A would aid the economic and efficient operation of the system by providing an additional route to market for non-UKCS supplies during an emergency situation. We consider that keeping the OCM open would at worst result in no change from the current arrangements, and by providing the additional route to market could result in more gas and LNG flowing into the GB market under an emergency.

Therefore, for the same reasons given above for Proposal 0149, we conclude that Alternative Proposal 0149A would better facilitate this objective.

Objective (d) - the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers

Some respondents argued that Alternative Proposal 0149A would facilitate this objective since by keeping the OCM open Users would have a greater opportunity to trade out their imbalances, thereby potentially lessening the extent and duration of an emergency. Ofgem believes that this proposal *may* facilitate competition merely by extending to Users the opportunity to trade on the OCM platform.

However, there is no evidence to suggest that Users would materially change their trading behaviour with no change in cash-out price signals under this proposal. We do not consider that the UNC Section Q post emergency claims procedure[14] provides sufficient economic incentive for Users to buy gas not already contracted above the frozen cash-out price, since at best they can only recover their costs, whilst exposing themselves to uncertainties surrounding the outcome of the claims process.

[14] The claims procedure is described in 4.2 of Section Q (Emergency Procedures) of the UNC. It describes the process by which a User can claim against a financial loss associated with being cashed-out at the relevant price.

Without dynamic cash-out pricing, we therefore conclude that Alternative Proposal 0149A only marginally facilitates this objective. Unlike Proposal 0149, we believe that the risk of unintended consequences against this objective is low under Alternative Proposal 0149A and to the extent they exist are largely a feature of the current arrangements rather than introduced by Alternative Proposal 0149A.

Objective (e) - so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

Since Alternative Proposal 0149A makes no changes to the cash-out price arrangements, we do not believe that it would change the way in which suppliers contract to secure the domestic customer supply security standards. We believe that suppliers should take into account the measures required to meet the security standards even under emergency conditions, and are concerned that the frozen cash-out prices under Alternative Proposal 0149A (as under the current arrangements) may not provide sufficient economic incentive.

We therefore conclude that Alternative Proposal 0149A is neutral with regards to facilitation of this objective.

Wider statutory duties

One respondent argued that both proposals could be detrimental to security of supply because having the OCM open may act as a distraction to Users who should be dedicating their efforts to co-operating with the NEC during an emergency. However, Ofgem concurs with the majority view that on balance having the OCM open should promote security of supply by providing an additional route to market for non-UKCS supplies. In the absence of dynamic cash-out prices we think this benefit would only be marginal though, since Users would have no additional commercial incentives to cover their positions in the event of an emergency. We therefore remain very concerned about the security of supply implications of the current arrangements and Alternative Proposal 0149A. The same respondent suggested that forward agreements with European parties may offer an alternative solution to dynamic cash-out prices for improving security of supply under emergency conditions.

Another respondent suggested that the NEC should direct NG to purchase non-UKCS supplies during an emergency, and that Users rather than NG should be suspended from using the OCM. Whilst we disagree with the argument that Users should no longer be incentivised to source non-UKCS supplies in an emergency, we do consider that the role of the system operator/NEC during an emergency warrants further review. There may be emergency scenarios where the System Operator would be best placed to buy non-UKCS supplies to manage the situation.

We do not believe sufficient analysis has taken place to determine how effective changing the commercial incentives on Users alone would be in maximising the flow of gas into the GB market. We ask the industry urgently to consider further whether the system operator should be able to buy non-UKCS supplies in an emergency and/or whether forward arrangements with counterpart system operators or other European parties are needed in conjunction with stronger economic signals on Users in order to enhance security of supply.

Finally, we concur with some respondents that further analysis is required of the potential impact of the proposals on the electricity market and its emergency arrangements.

Way forward

Despite our decision to accept Alternative Proposal 0149A, we believe that there remains a strong need to revise further the gas emergency cash-out arrangements in light of GB's growing gas import dependence. We believe that the risk of an emergency occurring is increased by the absence of significantly robust signals for Users to take all reasonable measures to cover their positions under a Gas Deficit Emergency.

We believe that Alternative Proposal 0149A furthers the relevant objective (a), and marginally (d), of Standard Special Condition A11(1) of the Gas Transporters Licence only to the extent that it corrects a potential 'anomaly' in the UNC. We consider that keeping the OCM open is likely to be a component of any future solution, but that it is not the solution in itself.

We are of the view that some form of dynamic cash-out pricing, or other alternative arrangement, is required to attract gas and LNG into the GB market under emergency conditions. However, there was insufficient information in the FMR to enable us to conclude that Proposal 0149 better facilitates objectives (d) and (e) of Standard Special Condition A11(1) of the Gas Transporters Licence, and we are concerned that the risks of unintended consequences in relation to this proposal have not been fully explored.

For the reasons we have set out above, and on numerous occasions previously, Ofgem considers it to be extremely important that the gas emergency arrangements are robust and appropriate. Not only is it vital to minimise the extent and duration of an emergency should one occur, but having appropriate emergency arrangements is also a crucial part of the incentive framework for ensuring security of supply.

We still have concerns that the emergency gas cash-out arrangements do not provide the appropriate incentives, and we were very disappointed that the FMR did not provide more rigorous analysis of each proposal, and provide further justification of the Panel's preference for Alternative Proposal 0149A over Proposal 0149.

We would urge the industry to examine these issues in more detail and to bring forward further proposals that address the need to revise the current arrangements.

Philip Davies
Director, GB Markets
Signed on behalf of the Authority and authorised for that purpose.