

Ofgem Review of Top-Up Arrangements in Gas

Comments from the Association of Electricity Producers

18 June 2004

The Association welcomes the opportunity to comment on this review of the top up arrangements, but is concerned that it was issued later than the associated documents relating to security of supply and at a time when the industry is awash with the current flood of consultations from Ofgem on both gas and electricity issues. This means that industry resources are being severely stretched and it is very difficult for sufficient resources to be directed to all these important issues simultaneously. We suggest that Ofgem should consider this when issuing consultations and setting the timescale for responses, so that companies will be better able to plan their resource allocation.

Our comments focus on the specific questions raised and the potential options going forward.

Top up and Transco's security of supply obligations

Is it appropriate that top up be used as a means of providing for 1 in 50 security?

The Association considers that suppliers are responsible for ensuring their customers' demand is met. Transco's role is to ensure adequate incentives are in place to encourage this via the cashout regime. If the cashout provisions are robust under severe conditions then it should not be necessary to intervene in the market, by the provision of top up, to provide this security.

Is top up primarily relevant for domestic customers?

The safety case does not appear to limit the use of top up for domestic customers only, in that it seems to say that top up gas is to meet deficits that are identified when gas supplies are assessed against firm demands, not only domestic demand. Customers who enter into firm transportation and gas supply arrangements expect to be provided with a firm gas supply.

Are the current top up arrangements consistent with Transco's obligation to operate the system in an efficient and economic manner?

The top up market offer price is only reflected in cashout prices when the offers are actually accepted. However the price of these offers will have an effect on the market whether the offers are called or not. If the top up market offer price does not reflect the underlying market conditions it may not incentivise the appropriate behaviour from shippers and may therefore not be consistent with the obligation on Transco to operate the system in an efficient and economic manner.

Potential options

The Association agrees with Ofgem's view that the options may not be mutually exclusive. We also consider that it would be sensible to consider pragmatic changes that are likely to be achievable before this winter separately from any longer term aims.

At the NT&T workstream meeting on 3 June, Transco reported that the monitor levels may need to be set even higher than the levels reported in the Winter Outlook Report.

The Association is concerned that if the monitor levels are set as expected, Transco may incur costs in ensuring that sufficient gas remains in store consistent with these monitor levels. In order to judge the possible magnitude of these costs it would be useful to understand what costs relating to top-up Transco has incurred historically and under a number of credible scenarios what the costs might be this winter. If in outturn the costs were

significant we would expect Transco to apply for an income adjusting event so that these costs might be included as allowed revenue or seek to modify the funding of top-up in the Network Code. As either of these would be retrospective and the costs would most probably be smeared rather than targeted this is not a desirable situation and creates charging uncertainty going forward.

The Association notes that shippers / customers are unable to influence some of these options as they are entirely between Transco and HSE or points of legal differences of view between Ofgem and the HSE.

- 1) The complete removal of top up from the network code (and Transco's safety case)

The Association agrees with Ofgem's initial view that conclusions from the 1998 review remain valid and that top up should be removed from the Network Code and Transco's safety case amended. The existence of top up could act to limit the incentives on shippers / suppliers to ensure they can source sufficient gas to meet their customers' demand.

However we recognise that the removal of top up from the Network Code and Transco's safety case is unlikely to be achieved before this winter, although this should be the long term aim even if other measures are progressed in the short term. In addition it might not be desirable if this were only achieved just prior to the winter such that shippers / suppliers were given little notice of this and only have a short time to adjust their supply strategies. It would be more appropriate to aim to achieve this in the spring such that shippers / suppliers would have more time to consider their supply strategies before the onset of winter.

- 2) Changes to the way Transco assess the need for top up gas

Given that we consider (1) is unlikely to be achieved for this winter, and the expected monitor levels are set so high, we believe there is merit in considering other pragmatic measures in order to avoid the potential costs and market distortions that could arise if actions are necessary to preserve the monitor levels. The Association agrees that anticipated market responses such as storage recycling and demand side response could be included in the overall assessment of the supply / demand position. Indeed NGT's Winter Outlook Report already considers that 2 bcm of demand side response would be required in a 1 in 50 winter.

However given the lack of experience of severe winter conditions, we recognise the difficulties that would arise from making an assessment of this kind. In addition companies are unlikely to be willing to disclose commercial arrangements or arbitrage strategies to Transco.

Any assessment of storage recycling or demand side response would be highly uncertain and industry confidence in this approach may be limited.

- 3) Transco to develop alternative ways of contracting to address supply / demand shortfalls – Ofgem view not a compelling case for developing such arrangements.

The Association is unclear why Ofgem considers there is not a compelling case for the development of alternative ways of contracting for top up such as demand side response, and forward contracting. We do however recognise the issues arising from such an approach; including funding, incentives and incorporation of the costs into cashout. Tackling these issues prior to this winter would be challenging given the current workload on industry representatives.

The Association considers that there may be a way of providing a market based approach that would not require any new funding arrangement nor changes to incentive or cashout. This approach would also if needed deliver a physical response that is measurable in realtime and would also allow the monitor levels to be reduced.

The outline of a possible way forward is detailed below.

- Large sites with daily metering or telemetry voluntarily opt-in to an arrangement where they will be obliged to place an agreed quantity of gas as a locational gas trade on the OCM on each day during the winter.
- The price will be determined by the shipper / site
- The site would have to agree to opting in, to protect sites receiving gas supplies from third party shippers
- Transco would need to use the market first before calling interruption for supply /demand reasons
- Transco's incentives would not need to be changed
- Cashout would not need to be changed
- Funding is via rules already in Network Code

As this approach would enable Transco to be confident that demand side response will be available it would be able to reduce the monitor levels accordingly, which in turn will reduce the risk of market distortions arising from actions to preserve the monitor levels. An arrangement of this type formalises what the market would be expected to do in terms of demand side response in severe conditions and may also reinforce the case for the removal of top up from the Network Code and Transco's safety case.

4) Modify the existing top up arrangements

Change the UIOLI rules so that top up counter nominations result in firm gas delivery. Transco has suggested that UIOLI capacity is not made available when top up counter nominations are being made.

The Association supports the principle of what this is trying to achieve ie to prevent the cycling effects that can occur if UIOLI capacity is used to withdraw gas that then requires further counter nominations. However we do have significant concerns that this could lead to inefficient storage utilisation, could limit storage cycling and lead to supply shortfalls that would have to be met, probably at higher cost, from other sources.

Publish storage stocks.

The Association supports the provision of inventory information to the market as this would improve transparency and facilitate a market response to possible breaches of the monitor level and ultimately enhance security of supply. We recognise that this would make Transco's top up actions more visible and that there might be the possibility of gaming but we consider the benefits of transparency of information and all parties having access to the same information outweigh these risks. We consider that it would be relatively easy to monitor for any unusual behaviour in this respect.

Calculation of the TMOP

The TMOP price should provide appropriate incentives under all circumstances, we have a particular concern that this price could limit the extent of demand side response the market provides and therefore inhibit shippers / suppliers from entering into commercial arrangements with their customers leading to inefficient intervention in the market.

- 5) Redefine top up such that it focuses only on the domestic customer supply security standards

Given that Transco has previously tried to amend its safety case to remove top up for non-domestic load and failed, and that this largely seems to be about how domestic security standards are interpreted, the timescale for resolution for this winter means that even if this were the preferred option then it may not be achieved. We consider that complete removal is the best option and resources should not be directed to this but rather to full removal.

- 6) No significant changes to the current top up arrangements

With the expected monitor levels set at such high levels we do not consider this to be a sensible option, given the market distortion that could arise if Transco needs to act extensively to preserve monitor levels.