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taking care of the essentials

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To Kyran Hanks
Director, Wholesale Markets
Ofgem
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17 June 2004

Dear Kyran -

**Review of Gas Top-Up Arrangements**

Centrica Storage Limited (CSL) offers the attached detailed comments in response to Ofgem's consultation paper on Top-up.

In summary -

- we accept that there is some lack of clarity as regards the concepts and role of Top-Up in the licences and Transco's Safety Case, but we consider that the removal of Top-Up activities would jeopardise security levels and that they should be retained, and further that it would be especially undesirable to withdraw the Top-Up protection as the UK enters a period where the supply/demand balance is widely expected to be "tighter" than in recent years

- we believe that the Top-up rules and calculations should apply to "all firm load" rather than just to the domestic sector

- we agree that the "counter-nominations" rules will generally increase the value and price of winter gas and winter flexibility and that the resulting higher potential exposures if storage inventories fall to the levels at which counter-nominations are triggered should increase shippers' incentives to prepare prudently - this should mean greater willingness to secure winter gas and peak-shaving of any practical form, including seeking greater access to demand-side flexibility, and we believe that the pursuit of the "1-in-20" and "1-in-50" criteria is sufficiently important that the prospective outcomes are favourable overall

- the Top-Up Manager's "Countering Injections" rules to prevent physical withdrawals to protect the "security monitor" will not necessarily have the desired impact - depending on the storage operators' contracts, the injection nominations may create more interruptible withdrawal capacity because withdrawal capacity is generally determined by physical withdrawal capacity plus any injection nominations: CSL continues to support a change to the generic SCA, as follows
    - all SCAs should bind the storage operator to accept "countering injections" from Transco, at prevailing lead times, unless this would cause a safety problem
    - a "countering injection" nomination from Transco should not contribute any addition to interruptible withdrawal capacity, which would be capped by physical withdrawal capacity plus injection nominations excluding Transco's "countering injection" nomination(s)
    - Transco would pay the resulting injection commodity and capacity charges, and also any space charges and withdrawal charges unless/until they sell their gas in store

- CSL would not in principle oppose the procurement of Top-up from non-storage sources providing there is sufficient comfort as to dependability and value

- as regards the funding of Top-up Costs, CSL agrees it is timely to review the Top-Up financing structure –

  - given that a Top Up requirement will occur in the event that Transco has failed to meet its Licence obligation to operate a network Code which provides appropriate incentives for suppliers to meet the security criteria, we still believe that there is a sound argument that Transco should bear the costs of Top Up
  - if nevertheless it is decided that funding arrangements should be changed so that Transco do not bear all the Top-Up costs, we agree that any net cost apportionment treatment should take account of Transco's "efficiency" in carrying out the activities which generated the net costs, and hence we consider that it may be most convenient to move to a cost-sharing treatment such that Transco retain an interest in minimising any net cost subject to the relevant constraints and obligations
  - CSL would strongly oppose reinstatement of the original Network Code treatment whereby Transco would recover Top-Up costs from shippers incurred by a "smear" in proportion to shippers' throughputs in the four winter months December-March - this approach failed to recognise that some shippers and suppliers may have made prudent security provisions whereas others may not have done so, and effectively discouraged those who might otherwise have tried to secure their realistic needs by forcing them to subsidise the other shippers
  - in CSL's view the most practical "cost-focusing" rule is likely to distribute Top-Up costs to shippers' based on aggregate under-deliveries over the key December-March period (ie based on the Modification 659 approach) but with the uncertainty reduced by declaring at least one day ahead the supplements payable from the time that Top-Up costs are incurred until any outstanding cost is reduced to zero
  - as regards the timing of any changes relating to Top-Up charges, any change should be agreed before the main interruptible contract renegotiation and storage capacity booking periods for a forthcoming winter, not after them, as otherwise shippers would have missed the main opportunities to mitigate any exposure to future Top-Up costs.

The Attachment provides comments in relation to the six "Options" advanced in the Consultation Paper.

Yours sincerely

Bruce Walker

Managing Director

**Attachment**

## Review of Gas Top-Up Arrangements – Centrica Storage Limited Comments

### The Need for Top-Up Rules

Centrica Storage Limited (CSL) does not agree that the Top-Up mechanism should be removed from Transco's Network Code and Safety Case. We believe that market forces should normally suffice to provide suitable security levels provided that shippers and suppliers are likely to face suitable commercial exposures if they fail fully to cover their commitments; but we believe the Top-up mechanism provides an important and valuable back-up without which the overall system security could in some years be unnecessarily reduced.

In particular, CSL believes that system security would be reduced if Transco's winter "counter-nominations" role and obligations were removed. Transco have stressed that system security is likely to depend upon "demand-side responses" on high-demand days when shippers and suppliers may have gas in store available as an alternative balancing tool, and we agree with Transco that they cannot be sure about the extent that interruption or load reduction would be used in such circumstances: the counter-nominations rules provide, in our view, a valuable and important protection to the system and for end-users. In the recent (mild) winters stored gas has often been used for peak-shaving in preference to demand reductions, and we believe that if the "counter-nominations" rules were removed the risk in future winters of failing to meet the full requirements of domestic customers would be increased and that there are no clear advantages justifying the removal of these rules.

Similarly, the risks would be higher if there was no process to ensure that storage stocks are ample at the beginning of the winter, so we support the retention of Transco's ability and obligation to inject gas in advance of the winter if the pace of injections raises doubts about the prospective security.

We thus favour retaining all the key components of the existing "national" Top-Up system –

- reviewing the security of gas demand and availability and storage bookings for the forthcoming winter early each calendar year and then as the year progresses, and if the prospective level of security is judged to be below the formal criteria then the Top-Up Manager would make additional storage bookings and to fill these bookings with gas
- if shippers then make later storage bookings the Top-up Manager would (subject to any contractual terms with the storage operators) reduce the Top-Up storage bookings accordingly, by "surrendering" the capacity, and may also dispose of surplus Top-Up gas held in store
- monitoring storage injections, and if there is a risk that booked storage capacity will not be filled at the start of a winter and this will jeopardise the security levels, buying gas for injection (in effect) into empty space booked by shippers, and later selling that gas if it becomes no longer needed
- monitoring storage withdrawals, and similarly if there is a risk that storage inventory will be reduced below levels consistent with the security criteria, buying gas for injection (in effect) into empty space booked by shippers, and later selling that gas if it becomes no longer needed

We accept that there is some lack of clarity as regards the concepts and role of Top-Up in the licences and Transco's Safety Case, but we consider that the removal of Top-Up activities would jeopardise security levels and that they should be retained.

We further conclude that it would be especially undesirable to withdraw the Top-Up protection as the UK enters a period where the supply/demand balance is widely expected to be "tighter" than in recent years.

### Relevant Market Segments

CSL essentially retains the view that influenced the industry to create the basis for the original Network Code rules relating to the determination of Top-up requirements, which we summarise as follows –

- if there is insufficient gas for "firm" customers, the load shedding systems are unlikely to be able to ensure that the demands of domestic customers are met in full and that any shortfall is accommodated by non-domestic customers, and therefore protection for domestic customers against any security criteria is best addressed by applying the same criteria (as far as is practicable) to the total needs of all firm customers
- there is a natural conflict between "operating the system in an efficient and economic manner" and providing for extreme circumstances, but the consequences of any material failure to provide sufficient

gas for the "firm" customers is likely to be very severe in cost terms and may have substantial safety implications

Hence we believe that the Top-up rules and calculations should apply to "all firm load" rather than just to the domestic sector.

**Transco's Forecasting of Supply and Demand**

Because Transco have not (to our knowledge) provided full details of their procedures for forecasting supply, demand and top-Up requirements, we can only provide limited comments on their processes. However -

- we are concerned that Transco have consistently over-forecast winter beach-gas availability: we would expect that Transco would be able to construct a reasonable retrospective set of estimates (by field and by producer) to match the overall gas deliveries in the past winters and that the availability for future winters would be estimated by forecasting the net changes (again, by field and/or by producer) – but we would not expect such an approach to have resulted in consecutive significant over-forecasts, as appears to have been the case
- the industry cannot expect any significant storage cycling within a severe winter of the type which would affect materially the Top-Up "stored gas requirement" estimates – we do not consider that "the potential impact of cycling could be substantial"
- our understanding was that Grain is likely to be available to export during nearly all of the 2004/5 winter irrespective of when the "effective date" is; but if the closure of Grain during the winter to change from "storage facility" to importation terminal would materially affect system security then we would expect NGT to delay the changeover to avoid any undue risk – and we do not believe that NGT would put the system or the customers at stake for the commercial benefit that an extra month or so of importation would offer
- we agree that the use of "undiversified" forecasts is inappropriate – and despite the many uncertainties we see no reason to plan for higher daily demands than Transco's network planning standard
- we do not think that any "price responsiveness from firm customers" can prudently be assumed in relation to a 1-in-20 peak day, which might occur with little forewarning given the difficulties of forecasting severe weather and the natural uncertainty in forecasting the demand/weather relation for severe conditions, but we do believe some such responsiveness is likely to emerge during a sustained severe winter, and problems may emerge outside the gas industry (eg in power or travel or delivery of raw materials to factories) which would constrain gas demand during such a winter

**Top-Up Monitor Levels**

CSL's view, as expressed above, that the load shedding systems are unlikely to be able to ensure that the demands of domestic customers are met in full unless security planning is based on the requirements of all firm customers, leads us to support in principle Transco's approach to determining the Top-up Monitors for inventory in storage facilities at levels where interruption can be expected.

As regards the requirements at lower demand levels, we agree that Transco cannot be sure as to the extent that shippers and suppliers will exercise interruption rights when they may have gas in store available as an alternative balancing tool. The experiences of recent years, albeit based on relatively mild winters, have been that stored gas has often been used for peak-shaving in preference to demand reductions.

In the absence of experience of a severe winter, there is no evidence that Transco's existing methodology in this area may be regarded as unduly "cautious". Therefore any relaxation might jeopardise the 1-in-50 security level, and we recommend that their existing treatment should be retained and supported until clear evidence is available to suggest that any proposed change would not jeopardise the desired security level, though we acknowledge that this may mean awaiting experience from a reasonably cold winter.

**Top-up Counter Nominations**

The paper discusses the issues and says that "counter-nominations could potentially lead to significantly higher prices and generate storage withdrawals at a significantly earlier stage than would otherwise be the case".

CSL believes the Top-up Counter Nomination rules are generally helpful, though a non-discriminatory change in respect of the "use-it-or-lose-it" rules (as discussed in the next section) is desirable.

The counter-nominations rules would only become effective if physical withdrawals from storage were considered likely to jeopardise the agreed security level, and would have the beneficial effect of "protecting" gas in store to increase the probability of such a level remaining achievable.

On days where Transco takes such action, which must be days when shippers are seeking to take gas out of storage and which would normally be after significant net withdrawals, the Transco nominations would create an additional demand and would therefore increase the market value of gas, perhaps significantly.

CSL suggests that the knowledge that Transco activities may generate high prices should have two main consequences. Within the winter, shippers should be concerned to ensure that they are not "short" of gas on the high-price days: shippers holding gas in store should value it more highly than if the counter-nomination rules were absent, and early in the winter this should tend to discourage storage withdrawals where demand-side peak-shaving can be used instead.

In advance of the winter, the rules should indicate higher potential exposures if storage inventories fall to the levels at which counter-nominations are triggered, and this should increase shippers' incentives to prepare prudently. This should mean greater willingness to secure winter gas and peak-shaving of any practical form, including seeking greater access to demand-side flexibility.

In CSL's view the potential outcomes are entirely favourable in relation to system security. CSL accepts that the rules will generally increase the value and price of winter gas and winter flexibility but believes the pursuit of the "1-in-20" and "1-in-50" criteria is sufficiently important to justify the retention of the Top-Up rules alongside the pursuit of efficiency and economic operations.

**Use-it-or-lose-it Rules**

In discussions on Transco's Generic Storage Connection Agreement and in our submissions to the various consultation papers, CSL has stressed that the Top-Up Manager's "Countering Injections" rules to prevent physical withdrawals to protect the "security monitor" will not necessarily have the desired impact: depending on the storage operators' contracts, the injection nominations may create more interruptible withdrawal capacity because withdrawal capacity is generally determined by physical withdrawal capacity plus any injection nominations.

At present, in the event of the Top-up Manager making a storage injection nomination to counter Shipper withdrawal nominations that would otherwise breach a 1-in-50 monitor, the Storage Operator (SO) might release further withdrawal capacity equivalent to that "counter nominated" by the Top-up Manager. If Shippers consequently increased their withdrawal nominations, a further "counter" nomination would be required by the Top-up Manager.

The Planning & Security Workstream members other than Transco considered that this might most effectively be addressed by a proposed change to the SCA, as follows

- all SCAs would bind the storage operator to accept "countering injections" from Transco, at prevailing lead times, unless this would cause a safety problem
- a "countering injection" nomination from Transco would not contribute any addition to interruptible withdrawal capacity, which would be capped by physical withdrawal capacity plus injection nominations excluding Transco's "countering injection" nomination(s)
- Transco would pay the resulting injection commodity and capacity charges, and also any space charges and withdrawal charges unless/until they sell their gas in store

CSL has said it supports this approach.

Transco welcomed the suggestion but, on the basis of legal advice, wishes to pursue the issue by a Network Code modification.

CSL does not support Transco's concept. CSL still believes that the issue is best addressed via the Generic SCA so as to bind all Storage Operators to a consistent approach and that the consequences should then be recognised in the SOs' contracts with their customers. SOs may not be Network Code signatories, so CSL believes a Code Modification cannot address the problem effectively.

**Storage as the only source of Top-Up**

As you are aware, consideration has been given over the last two years to securing Top-up services (and Operating Margins services) from sources other than storage, but the difficulties were considerable in relation to the potential benefits.

We are not sure that it is the case that the current approach "assumes automatically that the use of storage is cheaper than other options": we believe that storage certainly gives a good combination of effectiveness, dependability and value, whereas the recent discussions exposed concerns over how to ensure that any Top-Up service secured otherwise with only a low prospect of being "called" would be likely to be available if needed.

CSL would not in principle oppose the procurement of Top-up from non-storage sources providing there is sufficient comfort as to dependability and value.

**Incentive Effects of Top-Up Market Offers**

When the Network Code was created, it was widely considered that the Top-Up Market Offer Prices (TMOPs) would be the highest flexibility offers normally in place, and that they might create an incentive for individual companies to secure sufficient supplies in order to reduce their potential exposure to the relatively high TMOPs as if these might set system-buy cash-out prices.

It seemed however that the TMOPs did not have this effect: shippers and suppliers presumably considered that the risks involved were slight when weighed against the costs involved and the likelihood that lesser quantities of winter gas would normally suffice.

For 2002/3 and 2003/4 there were no TMOPs, and it is not clear that this had any material impact on system security.

If Transco should use the counter-nominations then the current TMOP rules would set sufficiently low offer prices for the gas that Transco had procured that they would be unlikely to become the highest offers available, and may (as your report notes) reduce shippers' exposures.

CSL does not believe it is practicable to regard TMOPs as a good basis for incentives to secure adequate winter supplies, but it is clearly undesirable that TMOPs are now likely to be so low as actually to reduce the incentives that would otherwise exist. Hence CSL supported Modification 671 which would increase the likely TMOP levels.

**The Funding of Top-up Costs**

CSL agrees it is timely to review the Top-Up financing structure.

We accept that the arguments in favour of Transco bearing the full net costs of Top-Up are not as strong as in the past, primarily since all LNG capacity available from NGT to third parties for seasonal storage and peak-shaving is likely to be sold out in future years.

We agree that any net cost apportionment treatment should take account of Transco's "efficiency" in carrying out the activities which generated the net costs. Hence we consider that it may be most convenient to move (maybe even as an interim measure) to a cost-sharing treatment such that Transco have an interest in minimising any net cost subject to the relevant constraints and obligations.

As regards the distribution of any costs to be borne by shippers, CSL would strongly oppose reinstatement of the original Network Code treatment whereby Transco would recover all Top-Up costs incurred by a "smear" in proportion to shippers' throughputs in the four winter months December-March. This allocated costs in proportion to shippers' contributions to Transco's mid-winter gas throughput. This approach failed to recognise that some shippers and suppliers may have made prudent provision for their commitments whereas others may not have done so, and effectively discouraged those who might otherwise have tried to secure their realistic needs by forcing them to subsidise the other shippers.

Ideally the costs would be focused on shippers with low coverage for their portfolios, but shippers can easily alter their coverage by buying and selling winter gas or storage capacity and/or gas in storage. Hence any shipper's coverage might be volatile as a year proceeds.

In CSL's view the most practical "cost-focusing" rule discussed to date (the Modification 659 approach) would recover from shippers any Top-Up costs in proportion to their aggregate under-deliveries over the key December-March period.

Normally on any day about half the shippers will over-deliver and half will under-deliver. If the shippers are aware in advance of the likely impact of Top-up cost recovery on under-delivering (albeit the scale would be very sensitive to the severity of the winter and hence subject to considerable uncertainty), they should have a clear incentive to make suitable advance provision for their loads. Some shippers should be prepared to sell gas which might move them from over-delivery to under-delivery providing the price is likely to cover any Top-Up cost exposure. We accept that this will tend to increase winter gas prices, but the fore-knowledge that winter gas prices would be likely to be higher (albeit with no certainty as to the scale of the Top-up recovery components) should encourage shippers to make more provision for their winter needs, and we would reiterate that we believe the pursuit of the "1-in-20" and "1-in-50" criteria is extremely important too.

CSL accepts that the Modification 659 approach would leave substantial uncertainty as to the additional charges to be borne in the event that Top-Up costs are incurred – even if the cumulative Top-up costs are declared as the winter progresses, the total quantity of the imbalances over which the costs would be spread would not be known.

Some of the uncertainty could be removed by, for example, declaring at least one day ahead the supplements payable until any outstanding Top-Up cost is reduced to zero. Various rules could be used to determine the daily supplements - to illustrate, one option would be to use the average level of daily under-delivery imbalances in the previous winter and to set the daily Top-up supplements so that the undistributed Top-up costs at any time (if any) are likely to be recovered over the next (say) thirty days, with an end-year residual Top-up neutrality "smear" as at present.

However, in contrast with the timing element of Modification 659, any such process needs to be agreed before the main interruptible contract renegotiation and storage capacity booking periods for a forthcoming winter, not after them. Transco have several times tried to change the funding treatment by means of Code Modifications, but to date Transco have always tried to change the Top-up rules for the forthcoming winter after the normal periods for dealing with interruptibles and booking storage capacity have elapsed, so shippers would have missed the main opportunities to mitigate any exposure to future Top-Up costs.

**Potential Options**

In the light of the above, CSL's has the following views in respect of the "six potential options" on which you invite comment –

**Option 1 – Removal of Top- up –** CSL is strongly opposed to this, for the reasons explained earlier.

**Option 2 – Changes to Transco's methods of assessing Top-Up** – we commented earlier on the issues raised in this report – naturally we would not object to improvements to the process, but it is not clear that all the changes floated in the report would be desirable.

**Option 3 – Alternative ways of Contracting to address supply/demand shortfalls** – we explained earlier that CSL would not in principle oppose the procurement of Top-up from non-storage sources providing there is sufficient comfort as to dependability and value, but previous discussions identified considerable difficulties, especially over how to ensure that any non-storage Top-Up service with only a low prospect of being "called" would be likely to be available if needed.

**Option 4 – Changes to the Existing Top-up Arrangements –**

- **Use-it-or-lose-it Rules –** CSL would support a change which would bind all SOs, and believes (as explained already) this would be best achieved through the SCAs
- **Publication of storage stocks** –CSL's position on publication of this type of information is that we have no objection provided the requirement to publish applies equally to all storage operators and, ideally, is in the context of a wider agreement or requirement to publish other equally relevant information including producing field availabilities. Meanwhile CSL already provides greater detail on its commercial activities and operations than offshore operators, terminals and other storage sites. Publication of aggregate inventory held in the three different types of storage information would discriminate against CSL and its customers as the "long-duration" information (which Transco published in 2003 without our agreement) shows Rough inventory while (for example) the publication of "short duration" inventory (which we do not think has been published by Transco) would conceal the individual positions at NGT's LNG facilities. While we understand Transco's concerns about system security, we thus contend that publication of weekly data for Rough but not for other facilities discriminates against our customers and against CSL. Again, we have argued that if Transco want storage inventory information to be published they should seek to make publication of the relevant data a commitment for all storage operators and that this is best approached by means of SCAs. However, Transco have not, to date, advanced any proposals in this area despite the ongoing reviews of the Generic SCA.
- **TMOP** – we earlier indicated that we support changes to the pricing rules, and we supported the changes proposed in Modification 671.

**Option 5 - Re-defining Top-Up to focus on domestic supply standards** – we have explained earlier that CSL believes that the load shedding systems are unlikely to be able to ensure that the demands of domestic customers are met in full unless security planning is based on the requirements of all firm customers.

**Option 6 – "do nothing"** – clearly, CSL favours a number of changes to the Top-Up rules and processes, but is not entirely in support of Ofgem's apparent preferences.

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