

Kyran Hanks
Director, Wholesale Markets
Ofgem
9 Millbank
London SW1P 3GE

Your ref
Our ref
Name **Steve Rose**
Phone **01793 892068**
Fax **01793 892981**
E-Mail **stephen.rose@rweinnogy.com**

18th June 2004

The review of Top Up arrangements in gas

Dear Kyran,

RWE Innogy, on behalf of its npower gas supply and shipping businesses, welcomes the opportunity to comment on the above consultation.

Top Up, despite having been a feature of Transco's Network Code since its inception, has never been used by Transco. During this time there have been fundamental changes in the structure and sophistication of gas supply and storage markets, and so shippers have no first hand experience on which to determine whether the Top Up arrangements felt to be appropriate and necessary almost ten years ago are still valid.

This year, however, on the basis of Transco's forecast of tightening in the supply demand balance there now appears to be a strong likelihood that Transco will have to intervene in the market, which could lead to significant disruption in the wholesale gas market. It is therefore imperative to review the appropriateness and efficiency of Top Up well in advance of the winter, unlike last year when Transco did not raise modification proposals until late October

In the consultation you ask for our comments on three key questions relating to Top Up and Transco's security of supply obligations. Our response to these questions is as follows.

Is it appropriate that Top Up be used as a means of providing for 1 in 50 security

In our opinion Top Up is not an appropriate mechanism for providing for 1 in 50 security. Also it is arguable whether Top Up has ever been appropriate bearing in mind Transco's right to interrupt for supply/demand balancing purposes and the 45 days of interruption available to Transco under standard interruptible transportation contracts.

The current Top Up arrangements are an anachronism, and there is real danger that they will introduce significant market in-efficiency this winter for little benefit to security of supply.

RWE Innogy plc

Trigonos
Windmill Hill Business
Park
Whitehill Way
Swindon SN5 6PB

T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rweinnogy.com

Registered office:
Windmill Hill Business
Park
Whitehill Way
Swindon SN5 6PB

Suppliers/shippers should be responsible for ensuring their customer's demand is met and Transco should be responsible for providing incentives to balance via the cashout regime. As stated in our response to last year's Top Up modification proposals, we believe that suppliers/shippers already have strong commercial incentives to ensure they are not short on high demand gas days and during periods of extended high winter demand. This was recognised by Ofgem when rejecting the modifications, and transferring the cost of funding Top Up as it currently stands will not strengthen these incentives further.

In our opinion the 1 in 50 security standard (if this is still felt to be an appropriate standard for ensuring security of supply) is best provided for by further development of gas interruption and demand side response arrangements, rather than restricting shippers ability to use gas storage in a manner they deem to be most economically efficient.

Is Top Up primarily relevant for domestic customers

Transco's licence requires them to ensure their Network Code provides reasonable economic incentives for domestic suppliers to secure that the domestic customer supply security standards are satisfied. In our opinion this condition is met through the cash out regime.

Top Up, however, and in particular the Stored Gas Requirement, is determined on the basis of the industry 1 in 50 demand curve and so is clearly relevant for all customers not just domestic customers. This is referred to in Transco's Safety Case and was confirmed by the HSE in February 2001 following legal advice.

Are the current Top Up arrangements consistent with Transco's obligations to operate the system in an efficient and economic manner

The current Top Up arrangements provide for Transco making winter counter injections to protect gas in storage that may (or may not) be needed to meet the requirements of a severe winter. This could create perverse incentives, as shippers who are short will be incentivised to take more gas out of storage in response to high market and cash out prices that arise from Transco's actions, thus further exacerbating the situation.

Under the current arrangements Transco may also be required to counter inject at the same time as they have called interruption for supply and demand purposes. This could prevent shippers withdrawing gas from storage in order to meet their firm gas requirements, which is likely to be one of the main reasons they booked storage in the first place.

We also have concerns that the expectation of Top Up market offers could have a dampening effect on cash out incentives, although there is little evidence available to judge whether these concerns are valid.

In our opinion therefore the current Top Up arrangements are not consistent with Transco's obligations to operate the system in an efficient and economic manner.

With this in mind it is appropriate to consider what options could be adopted to address the weaknesses of the current Top Up arrangements, and in response to the six options presented in the consultation document we would make the following comments.

Option 1 – The complete removal of Top Up from the Network Code (and Transco's Safety Case)

We share Ofgem's view that the most desirable option would be to remove Top Up from Transco's Network Code and Safety Case, although based on past experience we recognise this may be difficult to achieve in advance of this winter.

Option 2 – Changes to the way Transco assess the need for Top Up gas

We welcome Ofgem's assessment of the adequacy of the supply/demand assumptions used by Transco to derive the Top Up requirements Transco claim are needed this coming winter, and agree that these seem to include some apparent anomalies.

We look forward to receiving Transco's response to this assessment in Ofgem's 'Final Thoughts' document and would hope that this will result in them re-issuing the 2004/2005 Top Up Statement they published on the 28th May 2004.

We would also welcome greater transparency of how Transco forecast the 1 in 50 demand curve and determine the storage monitor levels. This, we hope, will lead to a wider industry debate on what security standards are appropriate for the GB gas market in future.

Option 3 –Transco to develop alternative ways of contracting to address supply/demand shortfalls

The inclusion of Top Up in Transco's Network Code creates a dis-incentive for Transco to develop alternative more flexible and efficient ways of contracting to address supply demand shortfalls. This is exacerbated by the fact that interruption is currently contracted for by Transco for both capacity and supply/demand management purposes.

Removing Top Up will encourage shippers, customers and Transco to develop more flexible market solutions for over-coming supply/demand shortfalls, although when considering such solutions it is important to recognise the influence that funding arrangements, incentives, security standards and cash out will have on their development.

Whilst we would agree with Ofgem that there is not a compelling case for developing such arrangements this winter, and that removal is the most appropriate option, it is hard to imagine the HSE will be persuaded to accept removal unless alternative solutions have been thought through and shown to be workable.

Option 4 – Modify existing Top Up arrangements

We agree with Ofgem that the modifications suggested by Transco to enhance the current arrangements do not materially address the weakness of the current arrangements and do not prevent the potential for significant market disruption.

The calculation of TMOP is currently subject to a modification proposal (671) awaiting Ofgem's approval. In our reply to the draft modification report we indicated partial support for the proposal.

We have also previously given our support for aggregated storage levels at different types of storage facility to be published so as to provide shippers with better means of assessing overall system supply and the likelihood of Top Up Monitors being breached. We are disappointed that this information has still not been published, particularly bearing in mind that Transco used the fact that this information would be made available last winter to support their Top Up modifications.

With regard to removing use it or lose it capacity when Top Up counter injections are being made, we support in principle what this is trying to achieve but have some concerns that this could lead to inefficient storage utilisation. We therefore consider it appropriate for any modification addressing this concern to be developed through the existing NT&T workgroup.

Option 5 – Redefine Top Up such that it focuses only on the domestic customer security standards

We do not believe that the issues surrounding the maintenance of sufficient supplies of gas to ensure firm demand is met in a severe winter are exclusively domestic issues. We also believe that firm non-domestic customers would be concerned by any proposal to revise the basis of the protection Top Up affords, however flawed, such that it no longer applies to them.

We do not believe therefore that this is an appropriate or equitable option to pursue further.

Option 6 – No significant change to the current Top Up arrangements

Based on Transco's preliminary supply and demand forecasts, and their published Top Up Statement, there is a significant risk of Top Up generating market distortions and of significant costs being incurred this winter in order to avoid a situation that may never arise.

The "do nothing option" is therefore not a realistic one and we note Ofgem's view that, other things being equal, the current Storage Monitor levels would not be consistent with the operation of a pipeline system in an efficient and economic manner.

Bearing in mind the scope for major change this winter is likely to be limited, it is important that Transco revisit their assessment for Top Up requirements in light of the issues raised in this consultation.

Until such time as Top Up can be removed, Transco should bear the full cost associated with taking Top Up actions under their Network Code. This will provide them with an incentive not to take actions or incur costs unnecessarily, which do not enhance security of supply.

To this extent Ofgem may consider it appropriate to issue a temporary informal derogation to Transco such that they would not be in breach of their licence if they failed to follow the Top Up rules specified in the Network Code. Transco would not be required (at least initially) to change to their Safety Case, and as they have "no obligation to ensure that 1 in 20 and 1 in 50 severe winter demand can be met by top up gas" (as stated in paragraph 2.20 of the consultation) they would not, we assume, be in breach of their Safety Case. Issuing a temporary derogation has been used to enhance security of supply once before, and so a precedent already exists for such an approach being taken if deemed appropriate.

Transco can, of course, at any time apply to have any Top Up costs they incur treated as an Income Adjusting event under their current price control. We would not however, expect Ofgem to accept this bearing in mind it has been their publicly stated position for over five years that Top Up is unnecessary and should be removed from the Network Code.

What must be avoided at all costs is a situation that arose last winter where two months into the winter shippers faced the risk of being exposed to significant costs that they could neither predict the likelihood of, estimate the impact of or mitigate their exposure to.

Should you wish to discuss our comments in more details please do not hesitate to contact me.

Yours sincerely,

Steve Rose
Economic Regulation