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Dear Kyran

The review of top up arrangements in gas

I refer to the above Ofgem consultation document. This document reviews developments in respect of top up arrangements since the Network Code was introduced and seeks views on the future use of top up.

Shell Gas Direct (SGD) has reviewed this document and considered the options being proposed by Ofgem. In our view, the complete removal of top up should continue to be considered now that the market has been liberalised. We note Ofgem's statement that there is no explicit reference to Transco having ultimate responsibility for ensuring that gas security standards are met.

We understand that it will be impractical to implement major changes for winter 2004/5. If top up is not to be removed from the Network Code, we would recommend (in order of preference): considering alternative ways in response to situations where top up actions may be taken which have fewer negative effects on the operation of the competitive market, eg development of forward contracts¹; amending the current approach to assessing the need for top up and considering other improvements to the arrangements; or redefining top up so that it focuses only on domestic consumers. We do not consider the current arrangements to be wholly satisfactory so do not support the no change approach.

¹ SGD's Modification Proposal 0699 suggests that forward contracting could be substituted for Transco's right to interrupt when demand is greater than 85% peak. Similar arrangements could be considered for the supply side.

Since the introduction of the Network Code, Transco has consistently raised concerns about the operation of the market in peak demand conditions and the issue has been debated extensively². As we have not had a severe winter, it is not possible to prove that Transco's claims have merit. It may not be appropriate to ascribe behaviour witnessed in the market during warm winters and expect it to be repeated in cold winters. It is the case that since the original arrangements were put in place, there has been considerable development of the competitive market arrangements, including the RGTA project in 1999 which increased incentives on shippers to balance their end-of-day position. Given this, we see no justification for keeping top up in place.

We consider the situation where Transco solely decides on top up requirements and monitor levels, and has extensive discretion as to its use could undermine market arrangements. The current assessment does not appear to fully incorporate likely responses of market participants, including the potential to re-inject gas into storage during lower demand periods (eg during warm spells, over weekends, and over the Christmas holiday period). We assume all market participants have access to weather data and that this information will inform decisions about the use of storage.

If the high monitor now proposed by Transco are implemented, there is the potential for interactions between shippers with their use of storage during peak demand and Transco with its use of top up to create price spikes not wholly reflective of market fundamentals, and which could work to obstruct market mechanisms. As such, we are not convinced that Transco's use of top up is consistent with its licence obligations to operate the system in an economic manner.

Given that it is unlikely that top up will be removed for this winter, it is important to consider how Transco will recover any net costs that it may incur through use of top up. Ofgem states that the only current instance in which Transco can recover costs is when top up gas is sold. This is not correct. If Transco does incur costs, it can approach Ofgem to recover these costs *ex post*. In its decision letter of Modification 0659 and 0660, Ofgem stated that "given the importance that Ofgem places on the issue of security of supply and to deal with any residual concerns that may manifest themselves this winter, it would be advisable to keep open the option of treating *efficiently* incurred top-up costs within the context of an Income Adjusting Event to Transco's price control." We commend this approach and reiterate our view as set out in response to consultations on these modification proposals that that an *ex post* approach is preferable for infrequent events³. The requirement for top up should be infrequent and while we recognise that the supply position could be tighter over the next couple of winters than has been experienced recently, the arrival of new infrastructure projects (LNG terminals and interconnectors) should ease the supply situation. The current perceived tightness of the market should not be used to maintain or introduce enduring arrangements to cover short term issues.

² From our records, there have been 18 modifications raised in relation to top up: M356, M367, M368, M424, M429, M451, M472, M495, M497, M504, M533, M548, M557, M583, M608, M639, M659 & M660.

³ Ofgem set out this principle in its document, "Supplier of Last Resort: Security Cover and Levies", June 2001, paragraph 4.21 that *ex ante* methods are generally preferred when an outcome has a high probability, or it is a frequent occurrence and an *ex post* approach is preferred when an outcome has a low probability, or it is infrequent

In considering this document, we note that while it is useful to draw on parallels between the gas and electricity markets as appropriate, we are concerned, however, that this can lead to inappropriate comparisons and therefore mistargeted solutions being proposed or implemented. We are not clear as to what role Ofgem considers suppliers to have in balancing inputs and offtakes from the system (footnote 1⁴). While suppliers in electricity have a role, in gas it is only shippers that have this role whether they are exiting gas to end-consumers or otherwise. Gas suppliers are better viewed as marketing and billing agents.

SGD continues to support the removal of top up from the Network Code. In the interim, we consider that Transco should only received funding for this on an *ex post* basis if it can demonstrate costs were efficiently incurred.

Yours sincerely

Tanya Morrison
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⁴ We are aware, of course, that domestic suppliers have obligations in respect to ensuring security of supply. This is done through contracting with shippers who are signatories to the Network Code and is not a balancing issue.