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Dear Colleague

NGT'S PRELIMINARY WINTER OUTLOOK REPORT – 2005/06

Ofgem has published today National Grid Transco's (NGT) Preliminary Winter Outlook Report for 2005/06. The purpose of NGT's report is to inform the market of any potential operational issues facing the gas and electricity systems in GB for the coming winter, particularly in the event of severe weather conditions. NGT's report provides information and analysis intended to assist market participants in assessing the potential risks to, and the interactions between, the gas and electricity markets this winter. The report also highlights any areas of the market rules that NGT considers should be reviewed ahead of the winter in the light of operational experience in previous winters.

It is not possible for any gas or electricity system to provide absolute guarantees in relation to security of supply. However, in order to ensure that there is sufficient resilience in the system to maintain security of supply in winter, even in the event of severe weather conditions, it is extremely important that market participants understand the key factors which can affect supply and demand. This allows the market – principally electricity generators, gas producers, energy suppliers and large industrial and commercial customers – to assess the risks associated with these factors and put in place appropriate commercial and operational arrangements to mitigate them. It also provides an opportunity for NGT and the market to consider raising rule changes ahead of the winter that would enhance security of supply.

This year, NGT has not proposed a 'central case' as in previous years, but is presenting a number of scenarios. These scenarios assess security of supply under a range of different demand and supply conditions in both the gas and electricity systems. NGT then presents sensitivities around these scenarios. As the level of demand is very sensitive to the weather, NGT has used scenarios that assess the supply/demand balance under average and severe weather conditions.

As highlighted in NGT's report, the main issues relevant to security of supply for this winter relate to the wholesale gas market. The key issues are the level of UK gas supplies that will be delivered this winter and the level of imported gas through the Belgian interconnector and the new LNG import terminal at the Isle of Grain.

NGT's analysis suggests that under normal weather conditions, there are sufficient gas supplies and electricity generation to meet demand. However, if gas supplies from UK producers, the Grain LNG import terminal and the interconnector are at the lower end of NGT's forecasts, some demand-side response will be required. Demand-side response is provided when large gas customers, including gas-fired power stations, reduce their level of demand. In this regard, large gas customers will take a commercial decision on whether to fix the price for their gas this winter or whether to be exposed to the spot price of gas for all or part of their demand.

Under severe weather conditions, NGT considers that a larger volume of demand-side response will be required for approximately half of the winter. If severe weather conditions combine with lower gas supplies then a significant volume of demand-side response will be required throughout most of the winter. NGT's analysis suggests that the bulk of the required response can be provided by gas-fired power stations without threatening security of supply on the electricity system. This can be achieved by running nuclear, coal and oil-fired stations ahead of gas and switching some gas-fired stations to run on back-up fuel or by only running gas-fired stations during periods of peak demand. The remainder of the response can be provided by other large industrial and commercial gas customers.

NGT's report invites the views of market participants on the outlook for this winter and NGT's analysis. NGT highlights a number of areas where it would welcome further information and views. Given NGT's analysis, Ofgem would encourage:

- ◆ gas producers and UKOOA to provide their views on NGT's analysis of available gas supplies this winter and evidence on the reliability of offshore gas supplies;
- ◆ electricity generators to provide their views on NGT's analysis of their ability to provide demand-side response;
- ◆ energy suppliers and shippers to provide their views on NGT's analysis of available gas supplies through the interconnector and the Grain LNG terminal; and
- ◆ energy suppliers and large customers to provide their views on whether they have in place the necessary commercial and operational arrangements to provide demand-side response under severe weather conditions this winter.

In its report, NGT also sets out what it considers to be ongoing developments to the industry code arrangements relevant to security of supply. NGT notes that a priority area for it is in regard to 'emergency gas cash-out'. Ofgem agrees with NGT that this area is critical to the efficient functioning of the market and therefore to security of supply. Ofgem considers that the current emergency gas cash-out arrangements, where, in an emergency, gas cash-out prices revert to a 30-day average of the system average price, do not properly reinforce the system of incentives designed to ensure that market participants contract for sufficient gas to meet demand in severe winter conditions.

Ofgem also considers that an important area of reform relevant to security of supply is in relation to information provision, particularly in relation to gas markets on the Continent. As GB becomes more dependent on imported sources of gas, it will become critical for the market to understand the supply/demand balance on the Continent to properly assess the risks associated with the availability of imported gas. In addition to these issues, the Authority is considering modification proposals in gas which are relevant to security of supply.

These proposals seek to remove the existing limited rights of NGT to interrupt large gas customers (such as power stations) for supply demand management purposes. The modifications are therefore designed to clarify the role and responsibility of gas shippers and suppliers in ensuring security of supply for their customers. The Authority intends to decide on these modification proposals shortly.

Ofgem's role is to help facilitate the efficient operation of the market. At the time of last year's Winter Operations Report, Ofgem announced a series of measures for market participants to consider ahead of that winter, and this year we are doing the same. Last year Ofgem approved the following changes that will remain in place this year:

- ◆ modifications to enhance information on mothballed plant and reserve fuel availability to NGT; and
- ◆ a rule change to enable power stations who decide to run over a short period of time to not pay a full year's payment of transmission charges.

This year Ofgem will:

- ◆ respond expediently to any modifications that are raised to the cash out rules in both gas and electricity, in so far as these rule changes enhance the operation of the market; and
- ◆ consider changes to further enhance the transparency of information in the market, and we urge parties to the consultation process to alert Ofgem to their views.

As in previous years, NGT will publish its Final Winter Outlook Report for 2005/06 this autumn in the light of responses received to this report.

Yours sincerely

ALISTAIR BUCHANAN
CHIEF EXECUTIVE