

The Joint Office, Relevant Gas  
Transporters and other interested  
parties

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Dear Colleague

**Uniform Network Code modification proposal 086 "Introduction of Gas Demand Management Reserve Arrangements"**

Ofgem<sup>1</sup> has carefully considered the issues raised in the Final Modification Report in respect of Uniform Network Code (UNC) modification proposal 086 "Introduction of Gas Demand Management Reserve Arrangements". Ofgem has decided not to direct the relevant gas transporters to implement modification proposal 086.

Ofgem considers that modification proposal 086 would not better facilitate the achievement of the relevant objectives of the UNC, as set out under Standard Special Condition A11<sup>2</sup> of the relevant gas transporters' licences, as compared with the existing provisions of the UNC.

In this letter, we set out the background to the modification proposal, a summary of respondents' views, the Modification Panel's recommendations and give reasons for our decision.

**Background to the proposals**

*Role of NG NTS as the System Operator (SO)*

National Grid (NG) National Transmission System (NTS) has two principal roles associated with keeping the system in balance. First, NG NTS is responsible for residual balancing of the system. To the extent that gas shippers' aggregate inputs and offtakes across all gas networks do not balance at the end of the day, NG NTS must buy gas to make up the shortfall or sell gas to offset the surplus so that, overall, the system remains in balance. Second, NG NTS is responsible for system balancing, which includes undertaking actions to keep the system within balance during the course of the gas day and to manage any transportation constraints on the NTS.

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<sup>1</sup> Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

<sup>2</sup> This Licence Condition can be viewed at:  
[http://62.173.69.60/document\\_fetch.php?documentid=6547](http://62.173.69.60/document_fetch.php?documentid=6547)

### *Role of shippers*

The UNC provides commercial incentives on gas shippers and suppliers to balance their inputs into and offtakes from the system by the end of the day<sup>3</sup>. These incentives are created by the 'cash out' arrangements that set the prices that shippers pay for shortfalls of gas (i.e. if its offtakes are greater than its inputs over the gas day) or are paid for surpluses of gas (i.e. inputs greater than offtakes). These arrangements are important for ensuring that shippers have appropriate commercial incentives to contract to meet their customers' demands for each gas day so that, overall, the system remains in balance. When shippers fail to match their inputs and offtakes, NG NTS, in its residual balancer role, undertakes balancing actions to ensure that the system remains balanced. It is important that the costs of these actions by NG NTS are reflected in the cash out prices, as this provides gas shippers and suppliers with the appropriate incentives to balance their inputs into and offtakes from the system. In turn, because of these incentives on shippers, which arise from the cash out regime, NG NTS's role as energy balancer is limited to a residual role.

### *Gas Safety Reserve Group*

During the early part of winter 2005/06, several modification proposals relating to the Safety Monitor arrangements<sup>4</sup> were considered and implemented. The modification proposals in question<sup>5</sup> focused primarily upon the compensation arrangements which apply in the event that flows from storage are curtailed during a Gas Safety (Management) Regulations (GS(M)R) Monitor Breach Emergency. In reaching decisions on these proposals, Ofgem outlined its intention to initiate a Gas Safety Reserve Group, involving market participants, including NG NTS, and interested parties, to consider whether the arrangements for securing gas safety reserve could be enhanced ahead of winter 2006/07.

Ofgem initiated the group in January 2006 and it ran until May 2006. The group considered options for revising the arrangements for securing the current required level of gas safety reserve (known as 'below the line') as well as options for acquiring additional gas safety reserve over and above that secured via the safety monitor arrangements (known as "above the line").

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<sup>3</sup> Although the network code arrangements only apply directly to shippers, these arrangements are relevant for other parties, such as suppliers, through the contractual and market arrangements in place.

<sup>4</sup> The purpose of the Safety Monitor arrangements is to protect those customers that cannot be protected by physical isolation and thereby protect public safety in the event of an emergency following a shortfall of gas. Under the arrangements, a volume of gas equivalent to the Safety Monitor level must be held in storage facilities for this purpose. NG NTS determines the amount of gas that is required to meet the Safety Monitor and allocates this between the storage facilities.

In the event that storage stocks at any or all of the storage facilities are close to or below the specified Safety Monitor levels, the National Emergency Coordinator (NEC) can declare a Gas Safety (Management) Regulations (GS(M)R) Monitor Breach Emergency. Under Stage 1 of a Monitor Breach Emergency, the NEC can instruct shippers and storage operators to amend storage flows.

<sup>5</sup> Modification proposal 052 "Storage Withdrawal Curtailment Trade Arrangements in an Emergency" and modification proposal 071A "User Compensation for NEC Storage Curtailment (Alternative)". Ofgem approved implementation of modification proposal 052 on 2 December 2005 and implementation of modification proposal 071A on 23 December 2005. The decision letters for both modification proposals can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>

At its meeting of 26 April 2006, the group concluded that it had assessed the available options thoroughly and that the appropriate way forward would be for market participants to raise UNC modification proposals as considered appropriate to progress any of these options ahead of winter 2006/07. Ofgem also highlighted the need to consider whether any changes are required to these arrangements ahead of winter 2007/08. Further details on the proposed approach for considering gas safety reserve arrangements ahead of winter 2007/08 will follow shortly.

#### *Electricity reserve arrangements*

National Grid Electricity Transmission (NGET) procures reserve services to ensure availability of operational reserves for balancing purposes. This form of reserve is pre-contracted by NGET and is provided by participants which can be called upon to deliver energy within defined timescales.

NGET currently procures standing reserve via an annual tender for the year ahead. NGET assesses tenders received to determine whether they are economic and efficient relative to other balancing options<sup>6</sup>. Parties who submit successful tenders receive an availability fee in exchange for being ready to provide the service and, if called, a utilisation fee for the volume delivered. Utilisation payments for participants within the Balancing Mechanism feed into imbalance price calculations when used and availability fees are added to imbalance prices based on a profile of expected standing reserve usage.

#### **Modification proposal 086**

Modification proposal 086 "Introduction of Gas Demand Management Reserve Arrangements" was raised by Gaz de France ESS as an urgent proposal on 19 May 2006. Ofgem granted urgent status to this modification proposal on 24 May 2006 for the reasons set out in the urgency decision letter<sup>7</sup>, which included enabling the modification proposal, if implemented, to be in place ahead of winter 2006/07 when demand management may be required to keep the system in balance and to avoid a Gas Deficit Emergency (GDE).

The proposal seeks to require NG NTS to put in place a tender scheme to encourage additional gas demand side response. This would be supplemental to the reserve secured under the Safety Monitor arrangements and so, in the context of the Gas Safety Reserve Group discussions, the modification proposal represents a development to the "above the line" arrangements. Key details of the proposal are as follows:

- ◆ **Tender** - NG NTS would conduct a tender process for gas reserve with shippers who (on a voluntary basis) submit offers for demand reduction on behalf of their customers. The terms of the tender process would be defined by NG NTS, in consultation with market participants and interested parties, but NG NTS would enter into contracts for reserve with the successful bidders who would then have a financially firm commitment to provide the service if called.

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<sup>6</sup> The transmission system is planned and operated to a 1 in 365 security standard – i.e. to ensure that there will be sufficient generation to meet demand in full on 99.73% of occasions per year (or in all but one occasions per year). This is a planning assumption made by NGET. NGET takes into consideration its 1 in 365 security standard when assessing reserve tenders.

<sup>7</sup> The urgency decision letter for modification proposal 086 can be found on the Gas Transporters Information Service <https://gtis.gasgovernance.com>

- ◆ **Payment** – successful bidders would receive a flat availability payment on entry to the scheme. Then, where called upon to provide demand reduction, participants would be paid a utilisation fee for the volume provided.
- ◆ **Imbalance price impact** – utilisation payments would be included in the calculation of the System Marginal Buy Price (SMP Buy) on days when called. Availability payments for the scheme would be included in the calculation of SMP Buy on a flat daily basis throughout the duration of the reserve contract period.

## **Respondents' views**

This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. Respondents' views can be found in full on the Gas Transporters Information Service<sup>8</sup>.

20 responses were received in relation to modification proposal 086 of which one response was confidential. Of the non-confidential responses, two supported the modification proposal, 10 were opposed to the modification proposal, five gave qualified support and two offered comments.

### *Respondents supporting modification proposal 086*

#### *Additional balancing tool for SO*

The proposer considered that the proposal would enhance security of supply and could be used by NG NTS to alleviate concerns over supply/demand balance on peak days, while avoiding exposure to very high prices. The other respondent in favour suggested that there is little evidence of demand side arrangements between shippers and consumers being put in place for this winter and so considered that this modification proposal may overcome this concern.

These respondents commented that removing barriers to demand side response could bring forward additional volumes that may not have been seen on a voluntary basis ahead of emergency interruption. One respondent felt that this could act as an additional buffer to protect storage monitors and another respondent believed the proposal would allow NG to take actions to avoid a potential GDE.

#### *Cash out implications*

The proposer considered that targeting the costs of the scheme into the SMP Buy price strengthens the incentive on shippers to balance and would also reinforce the "polluter pays" principle.

### *Respondents against modification proposal 086*

#### *Role of the SO*

A number of the respondents had concerns over the changes to the role of the SO as the residual balancer caused by this modification proposal. These respondents considered that the modification proposal would unnecessarily increase the role of the SO, distorting the operation of the market and increasing the potential for the emergency procedures to be invoked. Several respondents considered that the

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<sup>8</sup> <https://gtis.gasgovernance.com>.

increase in the SO's involvement would be contrary to previous efforts to minimise the residual balancer role.

Several respondents expressed concern that the modification proposal would blur the role of the shipper as a primary balancer and the SO as residual balancer, resulting in a lack of clarity as to responsibilities and additional complexity. Two respondents considered that this could risk weakening the primary balancing objective of shippers, with adverse consequences for security of supply.

Another respondent felt that a switch in responsibility to NG NTS becoming the balancer of first resort may crowd out the developing demand side response market and lead to NG having unfair advantage over shippers trying to offer the same service to customers.

#### *Incentives on shippers to balance*

Following on from the above, many of the respondents opposed to the modification proposal felt that changing the role of the SO would weaken commercial incentives on parties to balance. These respondents considered that the increased role of the SO would increase reliance on NG NTS to balance supply and demand and so create perverse incentives for users. Several respondents also had concerns relating to the impact of proposed revisions to cash out price calculations upon commercial incentives to balance. These points are considered in the next section.

#### *Cash out implications*

Seven of the respondents opposed to the modification had concerns over the potential impact on cash out arrangements, in particular the potential for the inclusion of the availability fee to distort cash out prices. Three of the respondents suggested that availability payments should not be included in SMP Buy calculations. Another respondent questioned whether applying a premium to SMP Buy every day was consistent with providing a commercial incentive for parties to respond appropriately to system conditions on the day. One respondent stated that cash out arrangements were designed to give an incentive to balance and not as a means to recover costs. One respondent opposed to the modification suggested that recovery of costs through neutrality would be a more appropriate alternative. Another respondent suggested that an exercise fee may place an artificial ceiling on cash out prices.

The potential delay in the calculation of cash out prices was a further issue that many respondents felt could lead to uncertainty over users' imbalance exposure. These respondents considered that there was a requirement for real time cash out price information to be maintained. There was also concern that any delay in cash out prices could distort the way shippers react to price within day.

#### *Additional demand side response*

Four respondents opposed to the implementation of modification proposal 086 considered that the proposed arrangements could undermine shippers' commercial arrangements for offering demand side response contracts. Several stated that the impact of the modification on shippers' commercial incentives could reduce the level of innovation and product development in this area. One of these respondents drew particular attention to the modification delaying any contract arrangements being signed whilst the decision on the proposal was outstanding.

A number of the respondents questioned whether the proposal would offer additional demand side response, as opposed to displacing demand side response that shippers would have contracted for anyway. Another respondent felt that the development of market arrangements and incentives to encourage active management of supplies and demand by the parties would be preferable to monopoly intervention as put forward by the proposal. In this context, NG NTS outlined that it does not consider that forward contracting for gas reserve in the manner envisaged by the modification proposal would be economic and efficient.

#### *Costs associated with proposed arrangements*

A number of respondents expressed concern about the potential costs associated with the arrangements and the potential for inefficiencies and cross subsidies to occur as a result of inappropriate distribution of costs. One respondent considered that the financial redistribution as a result of these arrangements would profoundly affect competition between shippers and suppliers.

#### *Modification proposal detail*

The majority of respondents opposed to the modification had concerns over the lack of detail and development of the modification. Three of these respondents drew particular attention to the fact that the lack of detail and development meant that it was difficult to see how more demand side response might be delivered. Another respondent commented that the proposal gives NG NTS significant discretion in areas that are of great importance and a high number of unknowns remain.

#### *Electricity comparison*

A number of the respondents opposed to the modification proposal considered that comparing the electricity and gas markets was difficult due to the structural differences between them. One of those respondents pointed out that in electricity reserve arrangements are intended to satisfy short duration near physical requirements and not major forward positions.

#### *Respondents offering qualified support*

There were five respondents who gave qualified support to the proposal. In general, these respondents were supportive of the principle of progressing initiatives to facilitate the provision of demand side response. However, they had concerns that the modification proposal was insufficiently detailed and so were unable to offer a definitive view upon the merits of the proposed arrangements.

#### *Respondents providing comments*

Two respondents provided comments in relation to the modification proposal. Again, these respondents were supportive of developments of the commercial arrangements for providing demand side response, but were of the opinion that the modification proposal lacked sufficient detail for them to make an assessment of the proposed arrangements.

### **Panel recommendation**

At the Modification Panel meeting held on 6 July 2006, of the 8 Voting Members present, capable of casting 10 votes, 1 vote was cast in favour of implementing modification proposal 086 "Introduction of Gas Demand Management Reserve

Arrangements". Therefore, the Panel did not recommend the implementation of this modification proposal.

### **Ofgem's view**

In deciding whether modification proposal 086 would better facilitate achievement of the relevant objectives of the UNC as set out in Standard Special Condition A11 of the relevant gas transporters' licences, Ofgem has carefully considered the views of respondents and the Panel.

Ofgem considers that, on balance, modification proposal 086 would not better facilitate achievement of the relevant objectives set out in Standard Special Condition A11 compared to the existing provisions of the UNC.

Ofgem considers that the modification proposal impacts on the facilitation of relevant objectives (a) and (d)<sup>9</sup> most significantly and we set out below the reasons why we believe that the proposal would not better facilitate these objectives.

#### *Relevant Objective (a) – the efficient and economic operation of the pipe-line system to which this licence relates*

##### *Roles of NG NTS and shippers*

The primary responsibility for balancing the system lies with shippers, who, through the cash out regime, have commercial incentives to balance their inputs into and offtakes from the system, with NG NTS having a residual balancing role only. Ofgem agrees with the view expressed by respondents that it is important that there remains a clear delineation of roles between shippers and NG NTS and that the arrangements encourage NG NTS's role in balancing the system to be kept to a minimum.

Our view is that the key features of the proposed modification could already be provided through the normal commercial interaction of shippers, suppliers and customers. Shippers and suppliers could, for example, replicate the arrangements set out in the proposal in their own contracts. The gas covered by such contracts could then be offered to other shippers or to NG NTS. We consider that shippers arranging for the provision of services through competitive processes is more economic and efficient than NG NTS undertaking the same activities as a monopoly business. Therefore, the proposed modification might potentially lead to NG NTS expanding its role into a competitive area to the detriment of the efficient and economic operation of the overall system.

A further risk in this regard is that if NG NTS is provided with a role in undertaking activities that previously have been the exclusive remit of market participants, there will be uncertainty as to which entities are ultimately responsible for the provision of these services. This uncertainty might, in and of itself, cause cost to be incurred as shippers may as a consequence have weaker incentives to seek to contract for demand management services. Indeed, we note that several respondents highlighted that they were actively seeking to develop further demand side arrangements with their customers in order to assist in balancing their own portfolios, and considered that the arrangements under modification proposal 086 could impair their ability to develop further

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<sup>9</sup> The relevant objectives are sub-paragraphs of paragraph 1 of Standard Special Condition A11 but are referred to in this document as paragraphs (other than in the text of a relevant objective) for convenience.

arrangements themselves. For this reason, we agree with the majority of respondents who considered that the proposed modification potentially blurs the roles and responsibilities of participants in the market to the detriment of the efficient and economic operation of the system.

#### *Incentives on shippers to balance*

As outlined above, the primary responsibility for balancing the system lies with shippers, with NG NTS having a residual balancing role only. The key driver for shippers to balance is the commercial incentive to avoid exposure to the imbalance prices determined under the cash out arrangements. We think that any changes to the cash out regime need to be considered particularly carefully, given that they are critical to the operation of a competitive gas market in which the role of the SO is kept to a minimum.

Modification proposal 086 has two important impacts on cash out prices. First, it feeds the utilisation fee associated with the use of a demand side reserve contracts into the calculation of cash out prices, such that, if this action is the highest priced action on a gas day, it will set the SMP Buy price. Second, it adds a 1/365 portion of the annual availability costs associated with the reserve contracts to the SMP Buy price on every day throughout the year.

We think that the proposed treatment of the utilisation fee incurred by NG NTS within the calculation of imbalance prices would be appropriate as cash out prices are designed to reflect the costs that NG NTS incurs in buying and selling gas to balance the system each day. This approach should ensure that cash out prices reflect the costs incurred by NG NTS in balancing the system and so provide appropriate commercial incentives for shippers to balance their own positions.

However, we share the concerns expressed by market participants in relation to the proposed treatment of the availability fee in the calculation of the cash out price. As mentioned above, we consider that it is important for cash out prices to reflect the costs incurred by NG NTS in its residual balancing role in order to ensure that the imbalance prices provide appropriate commercial incentives for market participants to balance. As the availability fee component of the proposed demand side reserve contracts would form part of NG NTS's overall costs, we consider that it is appropriate for these costs to be fed into the calculation of cash out prices. However, we share the view of some respondents that the proposal to allocate the availability fee into cash out prices across the whole year might distort cash out prices and shippers' incentives to balance.

As it is unlikely that the gas reserve contracts will be required on all days throughout the year, allocating the availability fees across all days on a flat basis is likely to lead to cash out prices that are too high on days when usage would not be expected relative to an approach in which the cost of the availability fee was more appropriately targeted. Conversely, this approach would lower cash out prices on days when gas reserve contracts are actually used, when it would be appropriate for a larger proportion of the availability costs to be targeted given that usage has occurred.

It is worth noting at this point that the approach proposed for the availability fee contrasts to the methodology adopted in the electricity market. Standing reserve contracts that NGET strikes with power generators and large load have an availability fee associated with them. However, in this case, the availability fee is targeted into cash prices in those balancing periods where it is considered most likely that the reserve contracts will be utilised. We believe this to be more cost



reflective than the approach suggested in this modification proposal, as it attempts to target NG NTS's costs into periods of expected usage.

In the context of modification proposal 086, of particular concern is the effect of the proposed approach on cash out prices on days when the reserve contracts are used. It is our view that the dampening of cash out prices on these days could undermine the incentives for shippers to balance their own positions. This would be particularly undesirable, as it is likely to be on these days that the gas supply-demand position would be most tight and, therefore, most critical that the shippers have appropriate incentives to balance their own portfolios. Overall, therefore, we are of the view that the impact of the modification proposal on cash out prices is likely to distort shippers' incentives to balance and so would not facilitate the efficient and economic operation of the system.

#### *Efficient and economic balancing tool for NG NTS*

NG NTS has licence obligations to operate the system in an economic, efficient and coordinated manner and has a number of tools available to do this, as defined in the Procurement Guidelines (PGs). We note that the proposer and several respondents considered that the introduction of gas reserve arrangements would provide an additional tool to NG NTS in its role as residual balancer, which could enhance the efficient and economic operation of the system and help to avoid a GDE. In principle, Ofgem is supportive of the development of appropriate balancing tools for NG NTS whenever these offer efficient and economic options for it to use as residual balancer.

However, in its response NG NTS states that it considers that the option of tendering for reserve contracts is already open to it under the existing arrangements and that it chooses not to enter into such contracts on the basis that to do so would not be economic and efficient. We also note that NG NTS considers that if the gas reserve arrangements envisaged under modification proposal 086 were in place, it has indicated that it would not enter into reserve contracts on the basis that they would not have adequate information to determine whether they would be economic and efficient. We also note that several other respondents considered that the proposed reserve contracts would not offer an efficient and economic balancing option. This is, however, countered by other respondents who believed that forward contracting for gas reserve might offer a more efficient and economic balancing option relative to taking on-the-day actions.

Overall, partly on the basis of the views received (and in particular those of NG NTS as SO), we do not think that it has been demonstrated that the arrangements proposed under modification proposal 086 would provide NG NTS with an additional balancing tool that would better facilitate the economic and efficient operation of the system.

#### *Additional demand side response*

We agree with those respondents who considered that the availability of additional demand side response would be beneficial as it would assist in balancing the system at times when there is a potential gas shortage (and therefore avoid the onset of a GDE). As such, we believe there is merit in developing arrangements for the provision of demand side response further.

However, we note that respondents provided conflicting views as to whether the contracts from the SO that might arise as a result of the proposed modification would actually deliver additional volumes of demand side response. Some

considered that the contracts would provide an additional route to market for demand side response not currently offered, largely due to the availability payment element of the contract. However, others considered that it was unclear whether the arrangements would provide demand side response supplemental to that already offered. Rather, the new contracts would simply displace existing commercially derived response provided via contracts with shippers. Ofgem agrees with those respondents who considered that the current arrangements provide the market with opportunities to enter into such demand side management contracts with end users. There would appear to be no structural reasons, for example, why an availability fee could not be incorporated into a contract between a shipper and end user if it were commercially attractive to do so. As such, it is difficult to assess whether the proposed modification will increase the aggregate volume of demand management made available to the market. For this reason we do not think that it has been demonstrated that the proposed modification would increase the overall volume of demand side response made available – rather it might just deliver the same volume through contracts with NG NTS. Therefore, we do not consider that it has been demonstrated that the modification would enhance the efficient and economic operation of the system via the provision of additional demand side response.

#### *NG NTS's assessment of reserve tenders*

We note that several respondents considered that the basis upon which NG NTS would assess reserve tenders was unclear. Ofgem considers that NG NTS's decision to procure and utilise a balancing service should be based on an assessment of whether it is economic and efficient relative to other balancing tools open to it. In the event that NG NTS was to enter into reserve contracts, Ofgem would expect its procurement decisions (i.e. the volume purchased and at what price) to be based on an economic and efficient assessment.

#### *Conclusions*

Overall, for the reasons outlined above, Ofgem does not consider that modification proposal 086 would better facilitate the achievement of relevant objective (a).

*Relevant Objective (d) – so far as is consistent with paragraphs (a) and (c)<sup>10</sup> the securing of effective competition (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers*

#### *Cash out price impact*

We support the intention to allow utilisation fees to set cash out prices when a gas reserve contract is the marginal balancing action, as this helps to ensure that cash out prices reflect the costs that NG NTS incurs. However, as noted above, we think that the proposed treatment of the availability fee is inappropriate as the costs of the fee do not feed into cash out prices in a manner that is likely to reflect costs on any given day. Proper cost targeting is important in preventing the distortion of competition. Consequently, as well as impacting upon the efficient and economic operation of the system, we share the concerns of respondents that the proposed treatment of option fees within cash out may distort competition between shippers.

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<sup>10</sup> Objective (c) reads as follows: “so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence”.

This is because shippers with short positions face exposure to inappropriately high imbalance prices on days when reserve contracts are not utilised and inappropriately low imbalance prices on days when reserve contracts are utilised. Therefore, on days when the system is tight and reserve contracts may be expected to be used, shippers who have short imbalances will not be appropriately cashed out for this imbalance. This undermines the commercial incentives on shippers to balance and has the potential to distort competition between shippers. Overall, therefore, we are of the view that the impact of the modification proposal on cash out prices could distort competition between shippers and so would not secure effective competition.

#### *Impact on shippers'/suppliers' demand side response contracting*

As mentioned above, we support the development of appropriate balancing tools for NG to use in its role as residual balancer where these can enhance the efficient and economic operation of the system. We also understand that shippers/suppliers are seeking to develop further demand side contracting arrangements with end customers. In this context, we note that several respondents considered that providing NG NTS with the ability to contract for demand side response would have a negative impact upon shippers' ability to secure their own demand side response. Respondents held this concern because of the view that NG NTS's involvement in the market would reduce the volume of demand response available to shippers, particularly given the perception that NG NTS would pay a premium for reserve. To the extent that the reserve contracts proposed do not deliver solely supplemental demand side response to that provided under the existing arrangements, Ofgem agrees that NG NTS procurement will displace some existing shipper procured response. This will, therefore, have a negative impact upon competition between shippers/suppliers for the procurement of demand side response.

In addition, we believe that the negative implications of the proposed cash out arrangements upon shippers' incentives to balance (as discussed above) will reduce their inclination to secure demand side response. This is because the cost of imbalance exposure on days when NG NTS utilises reserve contracts would not be fully reflective of the costs actually incurred by NG NTS, as a result of the proposed method of allocating the availability fee component into cash out prices. This may mean that imbalance exposure in these instances is less than the costs to shippers of actually securing additional demand side response for their own use. We think that this possibility would have a negative effect on shippers' incentives to procure demand side response and to develop new products with demand side participants. Therefore, we are concerned that the proposed arrangements would have a negative impact upon competition between shippers/suppliers for demand side response.

Overall, therefore, we are of the view that the proposed arrangements could inhibit competition for demand side response between shippers/suppliers and as such may not secure effective competition in this respect.

#### *Conclusions*

On balance, for the reasons outlined above, Ofgem does not consider that modification proposal 086 would better facilitate the achievement of relevant objective (d).

## **Ofgem's decision**

For the reasons outlined above, Ofgem considers that modification proposal 086 would not better facilitate the achievement of the relevant objectives set out in Standard Special Condition A11 compared to the existing provisions of the UNC.

Therefore, Ofgem has decided not to direct the implementation of modification proposal 086.

## **Wider issues**

Although we have decided to reject the proposed modification, we welcome the fact that market participants are seeking to develop arrangements for demand side response ahead of the winter and the impact of this modification proposal in terms of stimulating debate and discussion on these issues. Forward prices and NG's own winter outlook report<sup>11</sup> suggest that gas supplies are likely to be tight this winter. Against this background, it remains important to consider whether any further measures could be introduced to encourage more demand side response this winter.

In addition, Ofgem continues to believe that it is important to consider whether there is merit in developing the gas safety reserve arrangements further. Ofgem considers that it is appropriate to focus upon the arrangements for winter 2007/08 within this context. In order to initiate this process, Ofgem is planning to publish an initial thoughts paper later this summer which sets out areas and options for consideration ahead of winter 2007/08. The views of market participants and interested parties will be sought in relation to this paper and taken into consideration in the development of a way forward.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Simon Bradbury on 020 7901 7249.

Yours sincerely



Stephen Smith  
**Managing Director, Markets**

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<sup>11</sup> This is available at:  
[http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15693\\_MainbodyJulyfinaldoc070706.pdf](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15693_MainbodyJulyfinaldoc070706.pdf)