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11th November 2005

Ms Sonia Brown
Director, Markets
Office of Gas and Electricity Markets
9 Millbank
London
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Dear Sonia

Uniform Network Code (UNC) Modification Proposal 006 "3rd Party Proposal: Publication of Near to Real Time Data at UK Sub-terminals"

Please find attached UKOOA's response to your letter of 24th October 2005.

We naturally remain available to discuss this response and, indeed, we look forward to meeting you on Monday afternoon, 14th November.

Yours sincerely

Mike Tholen
Economics and Commercial Director

c.c: Rob Lally - DTI

UNC Modification Proposal 006:
Publication of near to Real Time Data at Sub-terminals

Introduction

UKOOA is pleased to be able to respond to Ofgem's letter dated 24th October 2005 regarding UNC modification proposal 006. In the short time available, we have attempted to answer the various points raised by Ofgem, but, as noted below, there are some items needing further consideration and questions which, UKOOA believes, should be addressed in the forthcoming Regulatory Impact Assessment.

Firstly, though, UKOOA wishes to record that many of its members have serious concerns about the authority under which the data attached to Ofgem's letter of 24th October 2005 was published and the manner of its publication, without consultation. UKOOA is still considering these matters and may wish to write to Ofgem separately about them.

Summary

- **Any assessment of the value of the data provided by Ofgem is, inevitably, going to be highly subjective; so, it is doubtful how much reliance should be placed on the outcome of this process.**
- **Four months through summer do not constitute a valid test of the worth of category 1 information of Phase III of DTI's scheme; it needs at least a full winter season and, preferably, a whole year.**
- **Focusing unduly on one set of market information such as the one released with Ofgem's letter of 24th October, but not others of equal importance, will lead to an unbalanced and potentially distorting result.**
- **Oxera's calculations for UKOOA in May 2005 demonstrated very little benefit of UNC 006 information over and above category 1 of Phase III of DTI's scheme and, possibly, dis-benefits.**
- **UNC 006 information is likely to induce greater price volatility and, therefore, higher costs for market participants.**
- **Ofgem has stated before that information should not be released to the market if it disclosed an individual company's commercial position; UKOOA would expect Ofgem to abide by this.**
- **Release of UNC 006 information will raise the perceived risk of investing in the UK continental shelf and so may affect the recovery of oil and gas reserves; this has not been considered and needs to be.**
- **Liability for the use of UNC 006 information has been overlooked; this should be addressed in the Regulatory Impact Assessment.**

General

With its letter, Ofgem has provided more than 80,000 items of data showing actual flows at most, but not all, entry points to the NTS for every two minutes during a week in September. Ofgem has requested market participants to provide their own estimates of the value and implications to them of release of such data to the market. This must, inevitably, be highly subjective; it is very difficult for anyone to assess properly and with accuracy how they would have behaved during a period some weeks ago, if presented with a different, albeit related, set of information from that which was available at the time. Therefore, it is doubtful how much reliance should be placed on these assessments.

Ofgem has noted that such estimates should relate to the position which has pertained since the very end of June 2005, when the final item of information of the three phase scheme agreed in March 2004 between DTI, Ofgem, Transco and UKOOA ("DTI's scheme") started to be published by Transco. We would have thought, though, that four months through summer and early autumn hardly constitutes a valid test of the usefulness of the data; it surely needs a full year to elapse and such a period should certainly encompass a winter season.

It does seem strange to UKOOA that Ofgem has only considered flows into the NTS. To understand market dynamics and, therefore, the value of such data surely requires information relating to other variables such as demand and linepack to be made available simultaneously. Indeed, all such information would need to be synchronised and in the same or similar degree of detail for consumers to benefit fully. To provide just one item of market information in great detail, but not all the others, creates an undue focus on this one component and thereby risks creating distortions.

Information Release

UKOOA fully supports the wider release of information to help the market, provided it is recognised that release of information relating to an individual company's operations should not occur, where this could prejudice that company's interests. This fundamental point was agreed by all four parties to DTI's scheme; indeed, Ofgem's letter of 23rd October 2003 states as follows:
"As we have noted previously, Ofgem considers that, generally speaking, information which is disclosed to the market on an ex-ante basis should be at a level of aggregation which does not disclose an individual participant's commercial position. Such aggregation could include, for example, zonal or national information."

As a result of the agreement in March 2004, categories 1, 2 and 3 of Phase III of DTI's scheme were aggregated into north and south zones (see attachment for tabulation of Phase III information). Such aggregation not only dealt with the matter of commercial confidentiality, but also minimised concerns about liability for any resultant use of the information.

Modification Proposal UNC 006

I. The first point to note is derived from Oxera's work for UKOOA provided to Ofgem in May 2005. Even in relation to pre-completion of Phase III of DTI's scheme, estimated benefits are £39m - £176m NPV over 15 years which is equivalent to 0.03 – 0.13% reduction in the wholesale gas price of 35p/therm. As a significant proportion of such benefits will be attributable to category 1 of Phase III, the amount attributable to UNC 006 will not only be much smaller, but may, as Oxera noted, be exceeded by the costs, leaving a net dis-benefit.

II. There is a significant risk that UNC 006 will increase market volatility. A body of academic research exists which demonstrates this effect, especially where published data are themselves of variable quality or subject to correction. This is the case with UNC 006 information; its very short term nature and inherent inaccuracies (ref Final Modification Report) mean that it is likely to be volatile which will lead to less efficient prices and increased costs for market participants.

By contrast, category 1 information of Phase III of DTI's scheme smooths such variations, while still providing the market with the important underlying data in a timely manner. The four parties to DTI's scheme recognised that accurate information provided hourly (category 1) would be more beneficial to the market than inaccurate information published promptly, as is likely to be the case with UNC 006.

In 2004 and 2005, there have been two periods of substantial volatility in the prompt markets: late January 2004 and end of February – early March 2005. The former was caused by supply-demand concerns when the Rough storage field suffered a failure and cold weather was forecast; the latter occurred during moderately cold weather in Britain when Inter-Connector supplies from Europe dwindled as a result of cold weather and supply difficulties on the continent. It is difficult to perceive that UNC 006 would have made any difference at all on these occasions, particularly when compared with category 1 of Phase III.

The part of the market which has caused participants the greatest concerns of late, because of its volatility, has been the forward market which lacks scale, maturity and liquidity (ref Global Insight's report for DTI). The effect of UNC 006 on the forward market, over and above category 1 of Phase III, is likely to be minimal, given the very short term, short lived nature of the information.

III. UKOOA has pointed out before, in its response of 24th June 2005 to Ofgem's Impact Assessment, that the 10mcm/d capacity threshold affects all beach-head sub-terminals and most new import terminals. As we have also noted, eight offshore fields can meet or exceed this rate of production.

It is therefore highly likely that if UNC 006 is approved individual company positions will be exposed to the market place, in the event of a supply failure. This would prejudice such a company's interests and be contrary to Ofgem's stated position in its various letters during 2003 and 2004 (ref our submission 16th March 2005).

Ofgem has suggested that a reduction in supply of 10mcm/d would raise the price of gas by 0 to 3p/therm (ref *Ofgem's probe into wholesale gas prices, conclusions and next steps, October 2004*). Under the current regime, a company placed in distress by such a supply failure has a period of time in which to enter the market and cover its position as best it can; this is also in accordance with the FSA's Code of Market Conduct as applicable to commodities. The larger the supply failure, the shorter the period of time for such action before the rest of the market discovers what is happening and reacts accordingly.

If UNC 006 is approved, such time will be severely limited and therefore expose a distressed company to rising market prices. Should this occur when demand is already strong, it is likely that the full 3p/therm identified by Ofgem will materialise. In these circumstances, a company will still incur not only a very high proportion of its own production costs (the vast majority of these are not immediately variable), but the cost of buying in the market which will be 3p/therm more than it would previously have been. The additional direct cost caused by UNC 006 will initially, therefore, be £106,000 per day, for each 10 mcm of production affected.

However, when the supply-demand balance is perceived to be tight, it seems likely that 3p/therm will be a significant under-estimate; importantly, it will be extremely difficult to determine in advance – each case will be unique. Recent volatility in prompt prices at the NBP which have varied by more than 20p/therm in the space of a few days is illustrative of what can happen.

A shortfall of 10 mcm of gas per day is very significant and probably indicative of a major failure which is unlikely to be resolved quickly. A company in such a position is, therefore, faced with a choice of buying ahead to cover itself for the estimated duration of the failure, or buying for a few days or a week at a time with the near-forward curve rising each time it does so, i.e. the premium will rapidly exceed 3p/therm (at 20p/therm, the cost rises to more than £700,000 per day). Either way, the company is faced with a direct cost which will soon be measured in many £millions. Indirect costs will be over and above this.

In addition, such indeterminate risk damages confidence in the investment climate of the UK continental shelf and, especially for the smaller, new companies whom the government is encouraging to invest here, presents a significant barrier to entry. This, therefore, undermines the policy of government and the efforts of industry to achieve the maximum, economic recovery of the nation's oil and gas reserves, with consequential implications for security of energy supplies.

Liability

In UKOOA's response on 24th June 2005 to Ofgem's Impact Assessment, we noted that liabilities arising from use of UNC 006 information had not been considered. It is almost impossible to estimate the costs involved, if claims for liability were to arise as a result of a market participant acting on UNC 006 information and subsequently discovering that it was erroneous.

In its Final Modification Report, Transco recognises this potential exposure for itself and/or the DFOs. UKOOA firmly believes that Ofgem should explain in the forthcoming Regulatory Impact Assessment how this matter is to be managed if UNC 006 were to be approved by the Authority.

Another consideration will be the need to re-negotiate a large body of agreements (also referenced in Transco's FMC) and the protracted timescale involved. Without a detailed review, it is difficult to estimate the costs and time entailed. Nonetheless, it is clear that such re-negotiations will absorb substantial commercial, technical and legal resources and, from past experience, probably take at least a year to accomplish.

Gas and Electricity

Throughout the whole debate about information disclosure, much has been made by various parties, including UNC 006's proposer, about the availability of information in the electricity market. However, in so doing, UKOOA believes that such parties have not properly recognised the differences between the gas and electricity markets and have incorrectly claimed that UNC 006 information is available for electricity, when this is not the case.

The physical reality is that the inputs and outputs from an electricity system have to match at all times. Electricity travels almost instantaneously; it cannot be stored. By contrast, gas travels slowly, it is compressible and it can be stored. There is no need to match inputs and outputs in a short timeframe; indeed, to do so would reduce market flexibility.

Commercially, electricity is balanced every half hour and gas every 24 hours. The nearest available information in the electricity market to UNC 006 is expected generation which is notified before gate closure; this occurs one hour before each balancing period. Thereafter, only National Grid can trade to balance the system . In the gas market, however, all participants can trade for 22 hours within the gas day, from 06.00 until the following 04.00.

The market exposure, therefore, to a significant supply failure in gas is much greater than in electricity. Conversely, there is an ability to catch up from a minor problem within the gas day and still remain in balance over a 24 hour period. This ability reinforces the point about not creating market volatility with very short term, potentially inaccurate data. Indeed, there are other practical and unavoidable considerations with gas production and delivery which have short term effects, such as the periodic need to "pig" pipelines. These may reduce flows for a few hours, before normal delivery is resumed.

Furthermore, as UKOOA has advised previously, there is no equivalent in electricity generation to the risk in performance of the reservoir which exists at all times in oil and gas production. In some cases, this risk can be worth tens or hundreds of millions of pounds and can threaten smaller companies' very existence and cause considerable damage to larger companies. Offshore, the weather and the marine environment add another dimension to production risks which are in very large part unknown onshore.

Conclusions

- The importance of sustaining investment in the UK's continental shelf should not be underestimated, if the maximum recovery of oil and gas reserves is to be achieved, in line with government policy. Any increase in perceived regulatory risk would damage confidence in the investment climate, especially for the smaller, new companies which government is encouraging to invest in the UK. This has implications for security of oil and gas supplies.
- Ofgem's chief executive has stated that Ofgem supports DTI's scheme and will only intervene further if it does not deliver (ref a meeting with UKOOA in September and a conference organised by Westminster Energy Forum in November). Insufficient time has elapsed to be able to judge the full effectiveness of DTI's scheme, especially with respect to category 1 information of Phase III. This requires at least a complete winter season and preferably a whole year.
- Modification proposal UNC 006 is likely to expose individual company's commercial positions to the market which the four parties to DTI's scheme recognised should not happen.
- Liability for the use of UNC 006 information has been overlooked, as UKOOA noted in its response of 24th June 2005. This omission needs to be rectified in the forthcoming Regulatory Impact Assessment.
- UKOOA is considering commissioning more work by Oxera examining further the implications of implementing UNC 006 and the issues which should be addressed in RIA; one such should be a "do nothing" case, in line with regulatory practice.
- Recent volatility and high prices in the gas market have arisen primarily because of the price of oil and the tightness of the UK's supply-demand balance. Lack of liberalisation in Europe and an illiquid forward market have also played their parts. Aside from the price of oil, the principal solution for the UK lies with increased gas supplies. These are, of course, coming through the extremely large, new investments which the international oil and gas companies are making. However, it does seem to UKOOA that there has been a tendency for too much emphasis to be placed on regulatory refinements, at the expense of broader considerations about security of supply and the scale and timeliness of the necessary new investment to achieve that.

UK Gas Supplies – Aggregated Information (Phase III)

In each case, Transco would be the aggregator of the information which it would publish on its web-site.

INFORMATION CATEGORY	TIMING & FREQUENCY	LEVEL OF AGGREGATION
1. Real-time flows into the NTS ***Available from end of June 2005***	As close to real-time as feasible	National and Zonal[1], also separately for: (a) storage; and (b) UK production and imports
2. Forecast flows into the NTS ***Available from mid March 2005***	Ahead of day Updated hourly through the day	National and Zonal[1]
3. Deliverability, reflecting planned maintenance ***Available from October 2004***	Ahead of time Quarterly, with material updates as they become known to Transco	National and Zonal[1], also separately for: (a) UK production and direct imports; (b) interconnectors; and (c) storage
4. Daily flows into the NTS ***Available from October 2004***	Daily at 16.00 hours on D+1	By sub-terminal

1. Zones: “north” and “south”, north comprising St Fergus, Barrow, Teesside, Burton Point, Partington and Glen Mavis; and south comprising Easington (including Rough), Theddlethorpe, Bacton, Isle of Grain, Dynevor, Avonmouth and Hornsea.

March 2004