Gaz de France

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Dear Sonia

Gaz de France ESS response to BSC modification proposal P194 Derivation of the Main Energy Imbalance Price Regulatory Impact Assessment

Thank you for the opportunity to respond to your Regulatory Impact Assessment for BSC modification proposal P194. Having been involved during the progression of this modification from its first presentation to the BSC Modification Panel through to attendance at your 1st February 2006 seminar outlining your preliminary 'minded' views, Gaz de France ESS remains firmly opposed to the implementation of this modification proposal. The following outlines our concerns regarding the impacts for our business and the wider community, should Ofgem decide to approve the implementation of this proposal.

Impact on Participants

Gaz de France ESS is a relatively new entrant to the UK market. We provide both gas and electricity offerings to our growing base of Industrial and Commercial customers, which includes a number of steel producers who have extremely unpredictable demand. In addition we have one CHP generation unit with an output capability of 215MW. We therefore do not fall into the category of a large vertically integrated company but one who is primarily a Net Supplier. It is of concern therefore that we read throughout this report that Gaz de France ESS belongs to one of the group of participants who will, in Ofgem's opinion, be most disadvantaged if this modification proposal is approved.

The P194 modification proposal was raised by National Grid Electricity Transmission (NGET) on the 26th August 2005 at a time when they were forecasting that the UK would experience severe winter conditions and concerns regarding Security of Supply were beginning to gain momentum. The severe conditions have not transpired and NGET have been able, at all times, to balance supply and demand requirements using mechanisms available under the existing baseline. Despite this improved outlook since mid December six independent energy suppliers have been forced to exit the market with Ofgem having to utilise for the first time their Supplier of Last Resort provisions, whilst UK consumers are facing the prospect of record energy bills.

Throughout the modification development process there was a clear and entrenched division of views regarding the merits of this proposal. In addition to the proposer only a handful of independent strategically placed generators were in support, along with one or two energy trading companies, who presumably will benefit from the introduction of P194 through enhancements to their range of 'hedging' products and more likely who are bound to benefit from an increase in near term volatility. Conversely this increase in volatility will adversely affect end users as it will have to be priced into their contracts. For the most part the large majority of the remaining modification group participants, consultation respondees and all bar one voting BSC Panel Member were against this proposal. Indeed, until presentation of the final report to the BSC Panel, NGET, as the proposer, was this modification's sole supporter holding a seat at the BSC Panel.

As mentioned above Gaz de France ESS serves the Industrial and Commercial community. Whilst building and enhancing our portfolio we strive to offer energy at competitive prices with appropriate levels of customer service. In order to ensure returns against our business expectations it is imperative that we minimise all risks to our business. This includes ensuring we are as close to a balanced position as possible in order to limit our exposure to imbalance cashout prices. Gaz de France ESS can only achieve this if our demand forecast is as accurate as possible and we purchase sufficient energy to meet our full requirements. This is exceedingly difficult when taking into consideration the volatility of consumption for some of our largest customers. Every effort is made to ensure we 'get it right' because if we do not this lost revenue is non-recoverable. We achieve this through utilisation of sophisticated forecasting tools, regular contacts with the largest sites, Real Time Monitoring and regular review of

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forecasting methodology. It is therefore of great concern that Ofgem are seriously considering a movement towards an even more hostile cashout regime. At a time when the management of transmission constraints is adding significant premiums to the overall energy price and Ofgem acknowledge that there is a risk that, under this proposal, a single trade acceptance could set the marginal cashout price, we find it difficult to understand Ofgem's rationale. This is of additional concern when taking into consideration the fact that NGET could accept a bid of up to £99,999/MWh if the industry continues their use of 'sleeper bids'.

Liquidity, Barriers to Entry and the likelihood of increased investment

Ofgem state within their impact assessment that P194 will increase liquidity. However the analysis proving that liquidity has reduced is based upon a limited set of post P78 data dating from May to November 2003 only. This does not appear to be as extensive as perhaps required.

Paragraph 3.38 begins with the observation that 'a cashout signal that better reflects marginal bids and offers could increase market participation in the balancing market.' Given that the basic idea of System Buy Price is that it is higher than the Market Price, thus incentivising participants to balance, as long as System Buy Price is greater than the Market Price then the cashout methodology is correct. At the very beginning of the P194 document Ofgem states and this is key to the whole argument, that participants take the view that System Buy Price will be less than the Market Price and therefore leave their positions deliberately short. Analysis shows that occasionally System Buy Price can be less than Market Price. However, what Ofgem need to investigate is why generators are willing to price their offers in the Balancing Mechanism at a lower price than that at which they are willing to sell on APX. As an example analysis for Period 36 on the 22nd January 2006 shows that the closing bid price on APX was £12/MWh higher than System Buy Price. This would suggest that it is not the unwillingness of short participants to buy which causes the system to go short but actually the unwillingness of generators to sell.

NGET's analysis of historic data shows that P194 would have on average a relatively small impact on the System Buy Price-System Sell Price spread, although it would create much more penal System Buy Price levels at time of system stress. It is therefore unlikely that P194 will act as a signal to increase investment in generation capacity, all the more so as such investments rely primarily on the price of electricity compared to the combustion fuel rather than assumptions on cashout arrangements. It is therefore our view that this proposal has very little relevance in terms of long term security of supply.

As it is extremely difficult for any non strongly asset backed and non vertically integrated supplier to source customers other than through a marketplace with decreasing liquidity and offering nothing but standard products, such a modification would undoubtedly discourage any new market player to enter the UK electricity market by increasing barriers to entry and severely impact the financial results of existing non vertically integrated suppliers unless customers are willing to pay for that risk.

Limitation of the original Data Set and Analysis

Gaz de France ESS attended the Ofgem Regulatory Impact Assessment overview meeting on the 1st February 2006. Along with many of the other attendees we were concerned at the limited analysis Ofgem presented to us, especially considering that NGET, the modification proposer, provided the majority of the data used within the analysis and carried out significant amounts of analysis during the assessment phase. The data used was from financial year 2004/5 despite the fact that we are now working within a 'BETTA' environment and suffering the adverse financial impacts of NGET constraint management. This issue is making a significant difference to costs going forward so therefore we would question the appropriateness of analysis based on pre BETTA data. In addition, we believe that it is probable that bidding behaviour under a P194 regime will be significantly different to that experienced to date. A participant bidding in at say £200/MWh in the past may be more likely to raise their bid to the same levels as some of the higher priced players. After all, if they fail to achieve their expected output, any shortfall will be cashed out at the price of the higher bidder.

Other general observations

Ofgem states within paragraph 3.55 that some participants may adopt a long position to mitigate against the rise of an increased System Buy Price. However for generators they would expect 'that market participants could manage the risk by part-loading some or all of their plants so that they could replace, at short notice, the output of their plants that happened to trip.' Currently participants are required by the Grid Code not to veer away from their output levels contained within their Final Physical Notifications. If a participant were to 'replace, at short notice, the output of their plants that happened to trip' post gate closure then NGET would issue a Serious Incident Report. Persistent behaviour of this sort could result in de-energisation. Pre gate closure this action would be deemed prudent amongst those players with a wide portfolio of generation. Many of us however are not so fortunate and will inevitably seek to ensure a long position. Is this really a more efficient outcome?

Lack of final output from Cashout Review Working Group

Ofgem refer to work carried out over the summer of 2005 by the Cashout Review Working Group. Gaz de France ESS was pleased to be able to contribute to the debate. However, we note with disappointment that Ofgem have not produced the final report referred to in the group's Terms of Reference. Such a document may have assisted industry, especially relevant to this consultation, regarding Ofgem's concerns about the current 'tagging processes'. Clarification around the timetable for production of this report would be appreciated. The Regulatory Risk faced by participants of further 'tinkering' post the P194 rejection, or implementation, period would be appreciated.

Conclusion

In conclusion Gaz de France ESS remains unswayed by the arguments submitted in support of this amendment. We remain concerned about the extent of any benefits post implementation, seeing only further adverse impacts on customers and non vertically integrated suppliers. Having seen the recent exits from the market we are concerned at the negative effect additional extremely volatile and unpredictable pricing will have in attracting new entrants.

Gaz de France ESS would be willing to participate in a review, once initiated by Ofgem. Should you require any further information please do not hesitate to contact Barbara Vest, our Regulatory Affairs Manager.

Yours sincerely

Eric Stab
Managing Director