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Sent: 14 May 2007 09:49

To: Andrew Wallace

Cc: Steve Smith

Subject: Domestic Supply Security Standards

Supply Licence Review: Consequential modification to special standard condition A11 (Network Code and Uniform Network Code) of the NTS and DN licences and standard condition 9 (Network Code) of the Gas Transporters Licence

Dear Andrew

Please forgive this reply to Steve Smith's letter of 27th April being a day or so late.

I fully support Ofgem's conclusion that the current domestic supply security standards obligation set out in the supplier's license does not place a practical requirement on the supplier. As such there would appear to be a clear case either for its removal or replacement by something that is more practical.

It is interesting to note in this regard, that the DTI October 2006 Consultation Paper appeared to place some considerable reliance upon the existence of this supplier obligation in order to meet relevant EU Directive requirements. I know that I was not alone in being somewhat surprised by this (continued) reliance, and the removal of the supplier licence provision would perhaps provide welcome support for those of us who have contended that the DTI has been somewhat optimistic in its interpretation of the effect of this provision.

Although Ofgem intend to transfer the salient definition of the domestic supply security standards to give continued effect to certain transporter obligations regarding network code arrangements, I would suggest that whilst this would solve one source of confusion, it would potentially compound another, since it would presumably imply that the relevant transporter licence provisions do impose a practical obligation on transporters of ongoing relevance.

However, as National Grid implicitly acknowledge in their letter (attached at Annex 2 to Ofgem's letter), the Network Code does not provide for any specific standard of domestic supply security. One must conclude after 11 years of Network Code operation that this either suggests a rather alarming breach of performance by transporter (and/or enforcement by regulator), or some tacit acknowledgement that it is not practical (or not welcomed by Ofgem) for the transporter to give practical effect to the requirement.

It is simply not the case that adherence to the terms of the Network Code delivers domestic security standards, not even when the security "fig-leaf" known as Top Up was a feature of the Code. The real reason for the supplier licence containing certain obligations applying in situations where gas is not shipped under the Code, was to discourage shippers from continuing to take advantage of certain legacy transportation contracts that pre-dated the implementation of the Network Code. The DTI adopted this approach (with some encouragement), as a more palatable alternative to simply rendering all such legacy agreements void, due to concerns about sequestration of existing rights. Of course, it may have been convenient back in 1995/6 for the authorities to convince themselves that the late concession of allowing Top Up in the Code would safeguard the nation, especially when questions were asked in Parliament about how the new regime would maintain existing British Gas security standards, but I do not feel qualified to give an opinion on such matters.

I see that National Grid suggest the replacement approach, in order to strengthen supplier obligations. Whilst I sympathise with their concerns, and welcome the idea of encouraging greater contractual transparency, I still have some reservations about any approach which directly or indirectly simply imposes the domestic security standard obligations on suppliers (without the current Network Code escape clause). I fear that such a standard would still be impractical to monitor (and enforce), and would at best only serve as an ex-post basis for the apportionment of blame. (I suspect National Grid have a fairly shrewd idea of where such blame would be apportioned once the impractical supplier obligation is removed altogether and the (impractical) transporter obligation retained.)

I therefore propose that the honest, transparent and simplest course of action would be for Ofgem to remove both the transporter and supplier licence obligations, and to make it clear that the UK does not feel bound by EU requirements in relation to domestic security standards.

The stark reality is that in a broadly competitive retail supply market such as the UK, it is simply unreasonable to expect individual competing suppliers to make independent provision for once in a lifetime events such as a 1 in 50 severe winter. This is the ultimate (and inevitable) irony of a competitive gas market serving the residential sector. Even if they wanted, suppliers cannot make a virtue of the "level of security" that they offer their residential customers, because there is no (currently economic) way of delivering differentiated levels of security to small customers sharing the same distribution system. Hence there is no basis for the retail market to value security at the individual supplier level, and suppliers will simply respond to their own model of risk and reward, knowing that unvalued investment in safeguarding against unlikely events will make them less competitive than their rivals. (This analysis need not apply to larger customers, although the ability of suppliers to ensure a defined level of security to such customers is potentially hampered by cross-subsidy effects explored below.)

However, the good news for the residential customer is that there is no consequential security of supply risk

(barring major infrastructure failure), for the simple reason that there is a significant level of supply to large "firm" customers such as power stations. This offers a very convenient cross subsidy to the residential gas sector in the form of a security comfort blanket, underpinned by existing gas safety management regulations.

In the event of a severe winter or extreme cold day, even though their suppliers will probably not have made adequate advance provision, there should still be plenty of gas that can be diverted in order to keep the distribution networks supplied. This might not even require emergency intervention if the market can react quickly enough at the time. Ironically, the suppliers of the residential sector will perhaps be hoping for early emergency curtailment to reduce the ruinous cash out prices that they will be facing (and/or the legal consequences of breaching the terms of their large "firm" supply contracts, if they have any).

If emergency curtailment is applied quickly (the "price majeure" response) and the balancing market suspended, the gas industry would survive relatively unscathed, and perhaps even avoid the financial failure of all but one or two major suppliers affecting the contracts of no more than a few million residential customers. This would perhaps also be accompanied by only a moderate level of power cuts as gas is diverted from generation to support the distribution networks. This will have the beneficial effect of reducing residential gas demand in those areas of the country affected by power cuts, since central heating pumps will cease working and helpfully reduce demand for gas and the need for further power cuts (the so-called "shivering safely in the dark equilibrium" scenario). If the balancing market responds quickly, with power stations and other large loads avoiding emergency curtailment by extracting full value from their "voluntary" curtailment, then we should be able to keep the commercial regime going until the last domestic supplier is left standing, the ultimate case of survival of the fittest (a true "supplier of last resort"). However, in either case, gas pressures should be maintained safely across the distribution networks, despite any inconvenient contractual and reputational damage to the gas industry.

Should it be decided that the UK does indeed wish to have gas security standards that meet or exceed EU requirements (without simply relying on a compulsory diversion of supplies destined for large loads), then there are possible solutions which need not offend market and/or regulatory sensibilities, and in fact could strengthen a considered demand side response in active competition with investment in other sources of flexibility such as storage.

However, as with any problem, the development of appropriate solutions can only proceed if first the need is truly perceived. In this regard a little transparency about the true worthlessness of existing supplier and transporter licence obligations would be a very welcome start by Ofgem.

Regards

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