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Project Discovery - Options For Delivering Secure and Sustainable Energy Supplies

Dear Andrew/Ian,

Introduction

ExxonMobil has invested heavily in the GB gas market because it has been confident of Government and regulator commitment to open competitive markets. The February consultation document, and the associated media reporting, raised important questions about Ofgem's objectives and whilst undoubtedly contributing to the energy debate, its Project Discovery intervention has so far only extended the uncertainty that GB investors face.

We were very disappointed to find that Ofgem had not fully taken into account the fifty five responses it received to its October scenarios consultation. Whilst Ofgem took on board some data corrections and dealt with future gas quality issues raised, the fundamental issues facing the power sector were not differentiated from the well functioning gas market and Ofgem did little to take into account the wide range of independent consultant material. We would ask that Ofgem review the effectiveness of its consultation procedures to ensure that responses are appropriately incorporated into its analysis and that its initial policy proposals are then modified accordingly.

Policy options were packaged under the broad description of "energy policy options" with no attempt in the headlines to distinguish the differences between the power and gas markets. Buried in the detail of the consultation document and only by looking at Ofgem's parallel consultation on liquidity in the wholesale power market, published later, does it become clear to the reader that the power market and power security are the principal concerns.

Despite these criticisms we remain committed to participating in this important project. We would refer Ofgem again to the views provided in our October consultation response which remain valid. We have contributed to the submission by Oil and Gas UK in respect of this consultation and below we provide more perspective as a producer-marketer on gas relevant aspects of Project Discovery.

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Project Discovery – Gas

The UK gas industry has grown over the last forty years as a result of many substantial and successful market led investments made at a time of stable government policy and predictable regulation; liquidity in the wholesale gas market has continued to grow and it is widely seen as one of the most efficient functioning wholesale markets in the world.

NGG illustrated this gas success story when presenting their winter to date update on 16th March. NGG noted that 30% of the gas supplied during this last winter was from new external sources delivered through infrastructure commissioned between 2006 and 2009. Prices were described as having been relatively benign throughout despite significant day to day swings in demand and the record demand days experienced in January. Although some customers were interrupted, this was for reasons that two local distribution networks experienced conditions beyond their 1 in 20 design, not because of any gas supply failure.

Ofgem argues that additional security risks accompany increased gas import dependency and lead to consideration of a number of policy options to manage security of supply risk , including (i) sharpening price signals (enhancing emergency cashout price, increasing incentives for firm supply in customer contracts), (ii) Public Service Obligations on suppliers to hold levels of forward firm gas supply, (iii) central tenders for the purchase of storage capacity, and (iv) gas quality blending (ballasting) schemes to ensure GB maximises its access to imported gas of varying quality in the future.

Two of these options, sharpening price signals and re-examining gas quality blending are already within Ofgem's remit and could be progressed with the gas industry now. It is entirely misleading for Ofgem to present these as new options to address future gas import dependence. PSO and central storage tender policy options are decisions for Government, each would appear to be a major market intervention, and the case for either of these options should be the subject of closer scrutiny. Once again neither of these options can be justified by GB's increased dependence on gas imports alone. The pace of private commercial gas storage investment is subject to market incentives and the policy outlook - clarity of the price signals in the gas market (which can be sharpened), and clarity of the policy on gas as a long term fuel in power generation (which is altogether absent) would substantially narrow the uncertainty for investors.

Project Discovery – The Consumer Interest

During the 16 March seminar presentation Ofgem clarified that a major intent of the project was to examine consumers interests and develop policy packages that it viewed as being in the consumers best interests; however it seemed clear from audience questions raised that Ofgem still have work to do to overcome consumer concerns about the costs and potential inflexibility of its investment scenarios.

Conclusions

The outputs of the consultation, as far as gas is concerned, rely on Ofgem's narrow assessment of additional risks of increased dependence on gas imports and associated future price volatility. Ofgem has not considered in any detail the major changes taking place in the international gas market which all point towards more gas supply, more supply diversity, more competition between external resource holders to supply global markets and therefore potentially less volatility. Industry and consumers should be afforded a detailed analysis on the global upstream market to help inform the debate on whether greater exposure to international gas markets carries the risk that Ofgem claim it does.

Ofgem's activities under Project Discovery appear to have been constrained by a decision to work strictly within the Government's policy framework and in our view that was an error of judgement - Ofgem could not in those circumstances provide a balanced supply demand analysis. An independent scenarios review may become important if Ofgem is to avoid criticism that it may have tilted the scales, whether knowingly or unknowingly, by acting as its own supply demand consultant. Armed with a full set of choices and all the relevant information consumers could be asked again by Ofgem for their views. The Mori polls and Consumer Panel activities that Ofgem reported at the 16th March seminar might produce a different outcome if consumers were aware of all the relevant information.

Gas policy options such as PSO's or central capacity tendering for storage, whilst politically attractive, may not be necessary and we would welcome a fuller scrutiny of need – there is however no reason for Ofgem to delay work to look at future gas blending requirements in GB or to examine how price signals and supplier incentives to supply can be sharpened.

In summary, the GB gas market is working well. There is plentiful and diverse gas supply and increasing competition between all players in the gas supply chain. There is a critical need for increased use of gas in the GB power sector in order to ensure security of power supply at reasonable cost and to help to meet GB emissions targets. We would urge Ofgem to highlight these key points in subsequent Project Discovery publications.

We trust that these views are helpful and will be happy to clarify if that were required.

Yours sincerely

Ian Trickle

Attachment - Response to Consultation Questions

We focus on the first five consultation questions and include a general reaction to the subsequent ten or so questions.

Questions 1 to 5 - Appraisal of Current Arrangements

Q1: Do you agree with our assessment of the current arrangements?

A1: No, we agree with some part of Ofgem's assessment and disagree with other parts as detailed below:

Cost and Availability of Finance (3.11 to 3.14)

Past significant external investment in the GB energy market, and particularly in the gas market, can be largely attributed as Ofgem suggests ..."*to the high degree of transparency and the perception that the risks of government and regulatory intervention were low*".

That perception is changing and perhaps the best evidence for that are the delays to gas storage investment. The root cause is the absence of a clear gas policy particularly in relation to gas use as a generation fuel and the resultant lack of clarity in forward gas demand signals. As long as Government and independent regulator discuss GB energy outlooks in terms of a substantial decline in gas use on one day and a dash for gas the next investors will see great uncertainty and GB gas market will be perceived as higher risk than those markets overseas where gas as is being encouraged as a fuel of choice. Ofgem needs to avoid the unintended consequences of its initial policy statements to ensure that it's prophesy of gas decline does not become self fulfilling.

Market Structure (3.15. to 3.19)

Ofgem comment (para 3.18) that *"there is a risk that such dynamics could impact the perceived riskiness of generation investments, such that, perversely, investments with stable operating and fuel costs (such as nuclear and wind) could be viewed by the Big 6 suppliers as more risky than investments whose costs vary with volatile global fuel costs"*

Ofgem's views here are surprising – in the first place future fuel prices and the degree of volatility in these can only be speculated on but we believe that the outlook is for stronger competition and diversity in the international gas market that will tend to reduce volatility. More importantly, investors will not see fuel price variability as a risk as long as retail prices are not regulated – on the other hand they will be much more concerned about risks associated with capital intensive investments such as nuclear and offshore wind – technology, planning , construction and operational risks.

Investment Signals in Generation (3.23 to 3.25)

Ofgem assert that increased dependence on gas in the generation mix threatens future decarbonisation of the power sector – we cannot agree as CCGT CCS offers the potential to overcome this concern and when expressed as the cost of clean electricity produced, gas is the most competitive CCS process of the fossil fuels. The recently adopted amendment in the Energy Bill that allows extension of CCS demonstration in natural gas fired power stations was a welcome step.

Issues with Current Market Rules (3.26 to 3.29)

Ofgem notes in 3.27 that "*in gas, the problem primarily manifests itself in the emergency cash-out arrangements. Firm load could be curtailed in an emergency with the cash-out price frozen well below the value of lost load for the customers being interrupted. If the price was able to rise in an emergency, additional supplies could be attracted from the Continent and from LNG, thus enhancing security of supply by reducing the risk of firm load curtailment*"

There is no evidence that increased import dependency will reduce GB security of supply and increases the risk of a gas supply emergency; indeed the huge potential of unconventional gas resources, growing diversity of gas sources, the opportunity for increased competition amongst producers and the costs and reliability of gas as a lower carbon fossil fuel are all positives for gas.

In the (unlikely) event of a gas supply emergency however, cash out prices may well be frozen below that necessary to attract the additional gas to restore supply – so this is an area that Ofgem and industry should take another look at. It may not be necessary to allow cashout prices to rise to the value of lost load to attract supplies and a proxy market price based on another European hub such as TTF or even Henry Hub may be sufficient.

Risk Management (3.34 to 3.39)

Ofgem asserts that "*the GB markets rely on price signals and the companies' response to these to deliver the desired level of supply security*".

We agree that a well functioning market delivering clear price signals are an important component of assuring security of supply especially in shorter time frames – i.e. once infrastructure to receive and distribute supplies has been built and is operating.

To attract future investments in gas infrastructure, there must be a <u>**supportive**</u> gas policy and regulation and a supportive Government and regulator. As an example of where regulation has not supported major new investment we point to changes to the tests for obtaining exemption to regulated third party access for major new infrastructure (Third Gas Directive).

Costs to Consumers (3.36 to 3.39)

We entirely agree with Ofgem that it would be completely undesirable of any policy or system of regulation to "*impact on the international competitiveness of GB's energy intensive industries*" ….or to be allowed to "*particularly affect those on low incomes and in fuel poverty"*

If Ofgem are taking the international competitiveness issue seriously we would have expected to see their comprehensive analysis about the future costs of unilateral UK and EU regulation such as the RHI, CRC EES, CCS levy and EU ETS Phase III.

Ofgem must ensure that the costs of future investment and supply are as efficient as possible for consumers – this can be achieved by actions that preserve the well functioning of the wholesale gas market and which promote gas as an important long term fuel source. For power there is clearly a need for some reform to enable an improved level of competition and wholesale market liquidity. We welcome Ofgem's recent proposals in this regard.

Interaction with Interconnected Markets (3.40 to 3.44)

Ofgem points out that there are supply risks caused by differences in GB (where supply relies on market price signals) relative to many other European countries where access to firm supplies may be partly dictated by the terms of the relevant PSO's. Such divergent arrangements are not consistent with the European solidarity model unless all supplies controlled by such PSO's are available for flow across all Member States. If GB were to introduce PSO's governing the extent to which a supplier has access to firm supplies in relation to his customer portfolio, there is a risk that other Member States act unilaterally to further strengthen their PSOs and a tit for tat race develops. Hence we would prefer that Ofgem advocates for the phased elimination of supply or stock related PSOs consistent with implementation of other security of supply related plans (including new infrastructure) across Europe.

"*LNG responsiveness to short term price signals in GB.*." is, we would agree, limited somewhat by the batch supply process associated with LNG. There is some ability to respond to short term price signals if terminal LNG inventory position between ship arrivals allows. We would expect responsiveness to improve over time as global LNG volumes grow, fleet sizes grow and more uncontracted LNG becomes available.

Additional commercial storage investment within GB and access by GB players to firm supply from continental storage are both solutions to ensure that the GB market can maintain adequate short notice supply security.

Ofgem seem concerned about potential overbuild of storage .."*ultimately costing consumers more*". But Ofgem's own scenarios indicate that gas demand outlook is so uncertain there is a risk of both underbuild and overbuild, or under-contracting or over-contracting of firm supply flexibility. In our view the risk of overbuild would exist whether or not storage build was dictated by competitive market processes or whether policy makers took a punt at mandating levels of firm supply flexibility for each supplier under a licence PSO.

The risks in GB storage investment would be substantially removed if there were a clear and supportive GB gas policy and a clearer signal on GB gas demand.

Q2: Are there other aspects of the current arrangements which could have a negative impact on secure and sustainable energy supplies, or costs to customers?

A2 :Yes, specifically the lack of a clear supportive gas energy policy and the inability or unwillingness of policy makers and regulator to discuss the benefits of gas in the overall energy context will, unless steps are taken to overcome this, result in increased costs to consumers and reduced security of power supply.

Q3: Do you agree that the five issues we have highlighted are the most important?

A3:No. Ofgem make five statements or assertions and we comment on each of these in turn

We do not agree with Ofgem's first assertion … "*that there is a need for unprecedented levels of investment to be sustained over many years in difficult financial conditions and against a background of increased risk and uncertainty*".

As long as policy makers and independent regulator fail to recognise the more significant and long term role that gas can play in the future power mix, consumer affordability and security of power supply stand to become more significant issues over the next decade. The "*need for unprecedented levels of investment*.." arise in large part because natural gas, the fuel that has warmed and powered UK consumers so reliably over the last thirty years is suffering from a policy vacuum, with the policy focus obsessively on alternative energy sources.

Ofgem further assert that .. "*the cost of raising the necessary finance could become very high if the investment is to be delivered ..requiring prices to rise correspondingly"*

We agree with this but these price rises only arise because highly capital intensive investments are being pulled forward, out of economic sequence, supported by consumer levies to meet unrealistic 2020 targets.

We also agree with Ofgem's assertion that …*"there are practical limitations on deployment of new infrastructure at this rate including planning, connections, technical barriers and constraints in the supply chain"*.

The costs and feasibility of investment in power generation based on gas fired power would be significantly lower but investment choices here have been artificially restricted, as a result of which consumers will face higher costs as well as less secure power supplies.

2. We agree with the first part of Ofgem's second assertion that .. "*the uncertainty in future carbon prices is likely to delay or deter investment in low carbon technology"*

Policy makers have the option of setting a carbon tax in GB (which would be hard) or lobbying for a minimum carbon price as part of the EU ETS structure or for a new EU carbon tax – each could encourage low carbon investment during periods when the carbon market itself does not provide a sufficient price signal. ExxonMobil supports revenue neutral carbon taxes as the fairest way of enabling low carbon developments **-** from a GB industry competitiveness perspective it is important that such taxes can be set on a Europe wide basis and ideally on a global basis to avoid the temptation for border taxes.

But we disagree with the second part of the assertion "*..that it will lead to greater decarbonisation costs in the future*".

Decarbonisation of the power sector is possible with gas in the generation mix. In the same way that CO2 capture and storage is being considered for commercial demonstration with coal, CO2 capture from gas CCGT remains possible to a similar extent.

3. We do not agree with Ofgem's third argument "*..that short term price signals at times of system stress do not fully reflect the value that customers place on supply security*"
We have considerable experience of what is a well functioning UK gas market (both in short term response and long term investment) and have found that market prices have been sufficient to match supply with demand and ensure security of gas supply. However, the lack of a clear supportive policy for gas into the future increases the risk of underinvestment in gas related investments going forward.

4. We disagree with Ofgem's fourth assertion that "*Interdependence with international markets exposes GB to a range of additional risks that may undermine GB security of supply"*.

Political considerations may override economic decisions impacting on the production of gas and the free flow of energy from international markets but we are only aware of one instance where the risk has been significant and GB was in any event not impacted. Similar political "risks" exist in the case of coal, nuclear fuel, the flow of labour or critical components in the supply chain required for wind power or other renewable technologies. These political risks are always present in the international markets and are managed through international trade agreements, intergovernmental dialogue between importers and exporters, and ongoing efforts to build and maintain good relations. The gas industry has continuously evolved on that basis and we believe the risk that Ofgem allude to are reducing and are no greater than similar risks to other energy sources that are interdependent.

1. GB already has the gas infrastructure substantially in place and proven operationally **-** to accept gas imports from Europe and all over the world.

2. The global outlook for new gas resources has never been better. US experience in the development of unconventional resources has demonstrated the global potential of unconventional gas not only in terms of reserves potential but in terms of diversity – there are likely to be over the coming years a significant number of new gas resource holders competing on the global stage, whilst LNG is the vehicle to optimise supplies across global markets.

3. The LNG market itself has grown considerably increasingly connecting all of the worlds gas resources **-** optionality and diversity for all importing countries is better than ever before and this trend looks set to continue.

4. The gas industry is not run on short term incentives in the same way as the financial industry has operated. It is an industry that makes long term investments with proven caution and financial discipline, and which has a reputation for delivering security of supply.

5. Finally UKCS indigenous gas supply remains an important feature of the UK market – and there is still much in the fiscal area that can be done to incentivise additional recovery of the UK's gas resources.

Ofgem's analysis on the changing nature of the global gas market has been weak and we would urge they give more attention to understanding the game changing nature of unconventionals and LNG. Properly informed, we would expect GB consumers would prefer to be more exposed rather than less exposed to the international gas market.

5. Regarding Ofgem's fifth assertion that "*the higher cost of gas" …"may mean that increasing numbers of consumers are not able to afford adequate levels of energy to meet their requirements and that the competitiveness of industry and business is affected"*.

   For reasons already given we believe that Ofgem are underestimating the ability of the gas market to compete on price and that the prices selected to make this assertion are speculative and perhaps convenient to leverage support for other scenarios.

Q4: Do you have any comments on our description of what might happen if no changes are made to the current arrangements?

A4: We do not agree with Ofgem's description of the consequences if changes are not made to current arrangements.

Supporting (rather than precluding) the choice of additional CCGT investment to fill the power supply gap is important to ensure that power supply security can be maintained to GB consumers according to the pace of alternative energy developments.

The construction of new CCGT should be recognized for its ability to reduce overall costs of new build in the power sector and for its contribution to reduction in overall CO2 emissions given that it will be mostly replacing retiring coal fired power.

We disagree with Ofgem's argument that additional CCGT would push demand up to the levels indicated in their Dash for Gas scenario – most commentators including National Grid Gas expect that gas demand will remain more or less flat over the period to 2025 as energy efficiency and other measures contribute reductions to any growth in the use of gas as a generation fuel.

Ofgem's analysis disappointingly demonstrates a failure to grasp the scale of changes taking place in the international gas market, the extent to which competitive pressures to supply gas to global markets is growing, and the advantage that GB has in attracting those supplies provided there is a supportive Government and regulator.

Q5: Do you believe that our policy packages cover a sufficient range of possible policy measures?

No.

What is missing from Ofgem's package is a description of a clear policy definition for gas as a generation fuel. Ofgem approaches gas as an incidental energy source, despite the heavy reliance that GB is already placing on gas to plug the gap as successive alternative energy schedules slip further back.

Nor do Ofgem convey any sense of the relative priority between affordability, security of supply and sustainability. These failures are surprising given Ofgem's outspoken approach in Discovery **-** the result is that Discovery has not (so far) dealt comprehensively with the affordability and security of supply issues that current and future consumers are faced with. Ofgem must recognise the long term role that gas will have in GB's future energy mix and work more closely with the gas industry to help explain its benefits to consumers.

Introducing a minimum carbon price, the first of the measures offered up, would be a very significant step by itself and if introduced unilaterally within the UK would impact UK's competitiveness. The other policy measures considered are increasingly revolutionary requiring more or less reversal from existing arrangements, creating the conditions for dispute, and further extending the period of uncertainty for investors.

Our conclusion is that both government and regulator should consider stepping back from the revolutionary approach to energy markets, and demonstrate a commitment to realistic targets in order to calm investor nerves and enable a more efficient longer term evolution of the gas and power markets.

Questions 6 to 16 (Policy and Timing)

We have limited ourselves to some general points on these questions:

- We agree with Ofgem that there is at least a 2 year window of opportunity to determine, consider and design any changes to current market structures. However we will defer comment on specific policy options for gas until all of the reasonable alternatives become a little clearer, including further work by HM Treasury and DECC under its Energy Market Assessment.

- The gas market continues to function well but in the continuing absence of a clear gas policy demand signals are being weakened and investment such as storage may for that reason continue to suffer.

- Gas security of supply is high on the political agenda, and although we believe that the markets ability to secure supplies is very robust we see that it would be prudent to look at compensation available to consumers for loss of load and the emergency cashout price i.e. to consider ways of sharpening price signals to further reduce the risk of shut-in and to ensure sufficient incentive for timely wholesale supply. The introduction of PSO's mandating minimum firm supply flexibility is not necessary; were this development unavoidable (and we would not understand why this would be the case), as long as suppliers have flexibility (choice) on how to comply with any Public Service Obligations this would be a lesser threat to the integrity of the gas market than the introduction say, of centrally organised tenders for GB gas storage capacity.

- Reviewing and taking steps to ensure that GB does not limit its access to global supplies for reasons of inadequate gas quality blending capability is amongst the most important security of supply related activities that we see for Ofgem in the next two years.