

The Gas Forum



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Dear Ian

Project Discovery: The Gas Forum response

The Gas Forum welcomes the analysis provided by Ofgem. This builds on the work included in the DECC / Ofgem Energy Markets Outlook. It is a sensible use of a regulator's resources to undertake holistic analysis in this way from time to time. Ofgem has correctly identified the major investment challenges facing the UK gas industry.

However, the Gas Forum is surprised by the Discovery conclusions particularly the proposed lurch away from competition and towards intervention. The Gas Forum agrees that "significant action" is required. However, it falls to the market – not the regulator – to undertake such action. The job of the regulatory authorities should be to provide a stable investment climate. The scale of intervention envisaged by Ofgem could in fact undermine the incentives to invest in Great Britain.

The Gas Forum agrees with the Government's view that

“ the risks of the gas market being unable to meet demand are very low, even in extreme scenarios and that there are no scenarios where there any involuntary interruptions to supplies”¹

Before addressing the questions put by Ofgem, the Gas Forum wishes to explain its own narrative with respect to the wholesale gas markets.

¹ Energy market assessment, Treasury/DECC, March 2010

The gas market has delivered

- Wholesale gas markets have delivered significant quantities of investment in the form of new sources of gas, pipes, storage and LNG import facilities;
- Infrastructure investment over the last 10 year has resulted in a five fold increase in import capacity to allow new gas to be brought to the UK (e.g. BBL, and the Milford Haven and Grain LNG terminals) from a diverse range of companies and countries while there has also been investment in a number of storage facilities;
- The wholesale traded market in gas in Britain is the most developed and efficient in Europe – and most of the new entrants to the UK market this year have been financial trading organizations so adding further liquidity;
- The market worked well during the recent cold winter as demonstrated by Ofgem's own analysis and the recent Winter Update from the National Grid, showing 30% of gas flows on the record demand day 8th January 2010 coming from new import infrastructure that came on line after 2005;
- Targeted and proportionate regulation has been an important part of this success story.

... the gas market will continue to deliver ...

- Looking forward, it is clear that gas, the related infrastructure and storage can be developed to enable demand to continue to be met;
- The DECC / Ofgem Energy Markets Outlook² shows the gas demand being addressed by a wide variety of gas supply and storage projects – the market is responding as would be expected; indeed DECC has just licensed a new storage facility³;
- While difficult scenarios are clearly possible, there is not much evidence that the market has not responded in the areas where they have control, such as investment;
- The Government's recent Energy Market Assessment also concluded that security of supply would be delivered by market arrangements (with any changes more focused on the post 2020 period);

² Energy Markets Outlook, DECC/Ofgem, December 2009

³ http://www.decc.gov.uk/en/content/cms/news/pn10_020/pn10_020.aspx

- The Gas Forum intends to carry out further analytical work to demonstrate that competitive markets will address the real investment challenges highlighted by Ofgem.

... regulatory intervention is not the answer ... in fact it may be causing the problem that Ofgem is seeking to address

- The Gas Forum has a concern that some of the Ofgem proposed interventions – eg “strategic storage” or reliance on “non-market mechanisms” – could hinder the very investment that Ofgem is highlighting – correctly – as being needed;
- So, the Gas Forum does not see a need for Ofgem to intervene in the way suggested.

... regulatory stability is a key investment driver ...

- It has long been recognized that a stable regulatory framework is key to attracting investment to to a competitive market;
- The fact that Ofgem is even consulting on some of its proposals has reduced the level of stability in the market;
- The Gas Forum does not consider that investment can be “switched off” for a year or two while Ofgem considers its proposals;
- The Gas Forum is concerned that there seems to be little co-ordination between the work of Ofgem and that of the Treasury / DECC; it is not quite clear who is in the driving seat of energy policy.

.... the Gas Forum notes that the Ofgem document appears to represent a change in Ofgem’s long-standing belief in competitive markets

- if this is the case, it is disappointing;
- if this is not the case, it is incumbent on Ofgem to re-enforce its continued belief in competitive markets – including for its valuable work in Continental Europe;
- It is also incumbent on Ofgem to be cautious in how its work is presented; the press coverage of Ofgem’s document was unnecessarily alarmist and should have been avoided by more careful drafting.

... the DECC / Ofgem Energy Markets Outlook show that the UK will become more import dependent with respect to oil and coal ...

- market intervention has not been proposed in those free markets even though significant investment is also required ... perhaps because those markets do not have a sectoral regulator ...

... but Ofgem and the Government do have an important facilitation and information role to play ...

There are things that the Government and Ofgem can do to facilitate the market -

- storage exemption regime
 - o Storage projects are still waiting guidance from Ofgem
- gas quality
 - o Work must continue to address the difficult issues associated with gas quality
- demand side
 - o Ofgem should continue its good work to enhance demand side response
- Information provision
 - o DECC and Ofgem should continue the good work contained in the Energy Markets Outlook, including identifying impediments to the connection of new sources of gas and storage

... in conclusion, the Gas Forum considers that the best way for investment to be incentivised would be the rapid confirmation by Ofgem that it will not intervene in the way proposed in the Discovery consultation.

Note: The Gas Forum represents gas companies supplying in the UK. It includes the following companies: BP, BG Group, Centrica, Corona Energy, E.ON, EDF Energy, GDF Suez, Good Energy, Npower, Scottish Power, Scottish and Southern Energy, Shell, Statoil, Total.

Individual members will of course have their own, and potentially differing views, from those contained in this response. This response was agreed for submission by the Executive of the Gas Forum.

In addition, the response covers only those matters related to the gas markets. We have not responded to the questions related to the electricity markets.

Answers to Ofgem questions

Question 1: Do you agree with our assessment of the current arrangements?

The Gas Forum does not agree with Ofgem that on-the-day reliability has been better than long term delivery of gas infrastructure. Government policy (or an absence of it) has also had an effect. The gas moratorium and delays on nuclear policy are two examples of policies that have held up investment. We hope that the impending election will not lead to a dramatic change in energy policy. The Gas Forum notes the recent publication by the Conservative party which seems more focused on market solutions than the Discovery publication by Ofgem. The recent DECC / Treasury document was also supportive of the market being better at delivery than intervention. All documents however envisage a level of intervention that the Gas Forum does not consider justified in the gas market.

The Gas Forum welcomes the Ofgem focus on the huge gas investments since liberalisation. Such investment has been delivered by market arrangements and proportionate regulation – such as exemptions from third party access requirements.

Another success of the gas market in Great Britain is the development of liquidity in the wholesale market. Ofgem's publication on liquidity in the wholesale market demonstrates this point.⁴ The proposed Ofgem intervention into the wholesale electricity market which acknowledges the robustness of the wholesale gas market also supports this view.

The Gas Forum is keen to ensure that any perceived problems in the electricity market are not imported into the gas market without proper and substantive analysis. For example, whatever issues there may be with the GB wholesale electricity market, there is no case for regulatory intervention in the GB gas wholesale gas market, which remains the most dynamic and traded gas market in Europe.

The Gas Forum notes that several important respondents to the first Discovery document were clear that major market intervention was not called for in the gas market. The Gas Forum considers that more weight should have been given to these views before publication of the latest Discovery document. It is also not clear what level of security Ofgem believes is lacking or is appropriate for the UK. We note that the share of gas in the energy mix is lower than many other European member states who are more heavily reliant on imports and yet there has never been a problem. We believe markets will deliver so long as they are well interconnected and capacity is sufficient to remove barriers to trade which will promote trading and security of supply.

⁴ Liquidity in the GB wholesale energy markets, Ofgem, June 2009, Figure 2.1

Question 2: Are there other aspects of the current arrangements which could have a negative impact on secure and sustainable energy supplies, or costs to customers?

From a gas perspective, there are four areas of the current arrangements which could have a negative impact on secure and sustainable energy supplies.

Gas quality

As the UK becomes more dependent on imported and stored gas, the well-documented issues associated with differing qualities of gas coming into the system will become more acute. This appears to be an area where Ofgem and/or DECC could usefully facilitate work to ensure that gas is not held off the system for technical reasons. There have been several reviews, including by the DTI into this area, but solutions are still awaited. One solution may involve the grid operator providing some form of gas blending service, on the assumption that any such costs would be directed to those companies causing gas quality issues. Regulatory clarity over which regulatory authority has oversight of the gas quality issues at Bacton would also be desirable.

Third party access

The second area relates to the current access and exemption regime for storage and import assets. This has been a key feature of Ofgem's success in attracting new facilities to the UK. However, the Gas Forum is concerned with the time it is taking Ofgem to process exemption applications and to offer guidance on third party access – and therefore exemptions from such third party access requirements.

Encouraging the demand side

The Gas Forum encourages Ofgem to continue its work facilitating the greater involvement by the demand side in providing flexibility to the gas market. The demand side has traditionally played an important role in delivering security of supply.

Review of emergency arrangements

It may be time for a wide-ranging review of arrangements in the event of a gas emergency. The Gas Forum does not therefore consider that a review of cash out prices in an emergency is the only aspect ready for review – or that emergency cash-out arrangements have any impact on investment decisions. Rather, such a review would include

- The role of National Grid – including whether it has built a robust enough system to allow gas to be delivered to market
- The order in which customers are taken off the system
- Contact details for larger gas customers

Question 3: Do you agree that the five issues we have highlighted are the most important?

The Gas Forum's views on the five issues identified by Ofgem are given below.

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

The Gas Forum agrees that substantial investment is required to deliver government's low carbon and renewable targets while maintaining security of supply. However, the implication that the market cannot deliver such investment is not sound. We note that the UK oil and gas⁵ companies are highlighting significant investment to extract remaining UK reserves. However, intervention by a regulator is not proposed as a solution in that industry. The Gas Forum considers that the gas industry will likewise – without regulatory intervention – deliver the gas and infrastructure necessary for the UK market. Indeed we can point to the planned expansions of existing LNG terminals, proposed new onshore and offshore LNG terminals and proposed expansions to existing, and development of new, onshore and offshore storage facilities.

The uncertainty in future carbon prices is likely to delay or deter investment in low carbon technology and lead to greater decarbonisation costs in the future

The Gas Forum considers that the uncertainty in future carbon prices is unhelpful. Nevertheless, the Forum does not believe that the energy regulator should intervene to correct a policy failure that is in any event beyond its remit. Such interventions risk causing "unintended consequences".

Short term price signals at times of system stress do not fully reflect the value that customers place on supply security which may mean that the incentives to make additional peak energy supplies available and to invest in peaking capacity are not strong enough

Ofgem considers that the suspension of price signals during a gas emergency is acting to deter peak gas provision. The Gas Forum does not consider that such prices are a fundamental part of a business case when considering such investment. Long term investments are based on long commitments and views of the market. The economics of such projects do not depend on occasional and extreme short term price variability although more regular occurrences will inevitably be considered during project planning. The Gas Forum does not therefore agree with Ofgem's analysis in this area, and are surprised that other mechanisms such as flexibility payments have not been considered. In addition, Ofgem has not explained why it believes economically priced gas will not flow to the UK during an emergency.

⁵ <http://www.oilandgasuk.co.uk/news/news.cfm/newsid/484>

However, as explained above, there may well be a case for a review of the arrangements that hold during a gas emergency.

Interdependence with international markets exposes GB to a range of additional risks that may undermine GB security of supply

The Gas Forum agrees that international interconnection exposes the UK to a range of different risks from a world of reliance on mainly UK sources of production and storage. However, such interconnection – through diversification – also gives extra security. We note the important role that imported LNG played during the 2009/10 Winter to achieve security in the UK. This is an example of diversity providing security of supply.

The higher cost of gas and electricity 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

The Gas Forum notes the tension between wishing to encourage investment (implying higher prices) and affordable supplies of energy (implying lower prices). It must be recognised that wholesale prices will probably have to rise in order to attract the necessary investment to the UK. However, the Gas Forum considers that this is a matter for Government and not the sectoral regulator.

Question 4: Do you have any comments on our description of what might happen if no changes are made to the current arrangements?

The Gas Forum does not consider that the case has been made for far-reaching changes to market arrangements. As such, the Forum is confident that market arrangements will result in gas and infrastructure coming to market in a timely way.

The Gas Forum is concerned in fact that some of the interventions envisaged by Ofgem will hinder investment. We note that Ofgem has argued in the past that strategic storage and public service obligations would hinder the development of competition in Continental Europe. Ofgem was right then and we see no reason why it has now changed its view.

The particular gas example used by Ofgem is seasonal storage. Ofgem has identified the lack of seasonal storage as “one of the biggest risks”. The Gas Forum agrees that the need for seasonal flexibility (including storage) will increase as supplies from the North Sea continue to decline. The Gas Forum believes however that there are projects in development which will address this need.

The policy proposals related to storage in the Discovery document cannot increase the incentives to invest. If the Winter-Summer spread is challenging – as suggested by Ofgem – the Gas Forum cannot see that “strategic storage” can do anything other than undermine any business case for new storage. Indeed, the mere fact that Ofgem is even consulting on such a radical proposal could – we believe – put such investments at risk.

Above, the Gas Forum has outlined that Ofgem does have a role in seeking to facilitate and incentivise such storage through timely guidance to, and consideration of, requests related to third party access and exemptions from requirements for third party access.

Question 5: Do you believe that our policy packages cover a sufficient range of possible policy measures?

Given that the policy packages include proposals that extend well beyond Ofgem’s remit – as is acknowledged in the Discovery document – the Gas Forum considers that the policy packages more than cover the necessary policy measures. The Gas Forum considers that Ofgem should consider a further scenario. That is, a “no substantive change” scenario. All the five packages conclude that “something must be done”. Ofgem – as it would be required to do in an impact assessment – does not provide a formal assessment of the status quo.

Question 6: Do you have suggestions for variants to these policy packages?

The Gas Forum has comments on the five packages as follows.

Targeted reforms

The Gas Forum considers that this is the safest (i.e. least interventionist) of the packages. Nevertheless, we note Ofgem’s repeated and continued attention to emergency cash-out prices in gas. The Gas Forum considers that while this issue may be due for re-review (given the rising importance of imports), the Forum considers that any changes in this area will not make any difference to the availability of gas in an emergency.

Ofgem refers to the Value of Lost Load as being the target for price rises. Ofgem should recall that VOLL was retired as a concept because there was no agreement as to how to calculate an appropriate value for the differing requirements of customers on the network.

The Gas Forum notes that Ofgem’s discussion of enhanced demand side management – which the Forum supports – does not include any discussion of its relevance in gas. This is disappointing and should be an area that Ofgem re-commits itself to addressing in gas. Related to this issue should be consideration by Ofgem as to whether the current interruption regime remains fit for purpose. The impact on customers could be re-considered.

Enhanced obligations

The Gas Forum considers that there may be a case for some form of enhanced obligations in order for all the Government's targets to be met. Some form of targeted obligation to facilitate the delivery of security of supply may be appropriate.

The Gas Forum notes that Ofgem has spent many years arguing against public service obligations with respect to Continental Europe. The fact that Ofgem is now considering a reversal in this area will send conflicting messages to other jurisdictions where competition is not as advanced as in the UK.

The Gas Forum notes the proposal to allow the gas system operator to buy gas to avoid gas emergencies. Ofgem should recall that it was Ofgem that removed the need for "top-up" gas as it was deemed to be inefficient and unnecessary. Again, Ofgem's changing views on similar issues risks sending confusing messages to market participants.

The Gas Forum does not support further obligations on CCGTs.

Enhanced obligations with renewables tenders

The Gas Forum has no comments to add to those made above.

Capacity tenders

The Gas Forum does not support the concept of capacity tenders for gas and related infrastructure. The Gas Forum considers that any scheme to mandate a centrally-determined level of gas storage will directly undermine the incentives to deliver gas storage. Indeed, the fact that Ofgem is consulting on such proposals has we believe begun to undermine incentives to invest in gas storage. Concepts such as "strategic storage" are particularly dangerous for investment incentives.

The Gas Forum would also be cautious about the regulator having the ability to require suppliers to contract for a particular level of physical delivery. The natural caution of authorities would be to require companies to commit to over-delivery for the "rainy day". Such requirement to "over deliver" will lead to higher prices than necessary for customers. The Gas Forum would therefore oppose Ofgem having the ability to require suppliers to contract for a particular level of supply.

Central energy buyer

The Gas Forum does not support this proposal. The Gas Forum considers that a more careful presentation of this particular proposal would have resulted in a more balanced reporting of its proposals. The Gas Forum does not consider that the press coverage has been at all helpful in creating a stable investment climate. The Gas Forum is particularly concerned by the relaxed, even casual, view that Ofgem has taken to press coverage in this regard.

The message that consultation on this concept has given to the rest of Europe is of particular concern. From being a cheer-leader for a competitive market, Ofgem's apparent change of heart can do no good for the promotion of competition in Europe.

Question 7: What other policy measures do you believe should be considered, and why?

The Gas Forum has no further policy measures to propose for the UK gas market.

Question 8: Do you agree with the assessment criteria that we have used to evaluate the policy packages?

There would be four further aspects that the Gas Forum considers should be addressed by Ofgem in any further policy assessment.

- First, Ofgem should assess the overall effect on investment in the gas market of its proposals. Broadly, the more extreme the intervention, the bigger (negative) effect on investment incentives.
- Second, Ofgem should explain how any proposal is consistent with its primary duty which involves promoting competition wherever appropriate. Since Ofgem's duties have not changed, then the ex ante assumption must be clearly that a pro-competitive solution should be preferred to market intervention. Where analysis was balanced, then a competitive market should be a default option for any proposal. It is not clear from Ofgem's analysis how some of its proposals are consistent with its duties as drafted.
- Third, Ofgem should explicitly consider which package – if any – was going to most quickly return the market to the relatively stable investment climate that existed prior to the publication of the Discovery document. That is, a quicker solution should, ceteris paribus, be considered superior to one involving longer timescales.
- Fourth, with respect to any proposal, Ofgem should consider the impact on the development in the Continental gas markets of the UK being seen – partly due to the press coverage of its proposals – to abandon its belief in competitive markets.

Question 9: Do you have any comments on our initial assessment of each of the packages?

The Gas Forum has no further comments on Ofgem's initial assessment of the packages.

Question 10: Do you agree with our summary of the key benefits and key risks of each policy package?

The Gas Forum considers that the criteria outlined above should be added to Ofgem's consideration.

Question 11: Do you have a view on which package is preferable, or alternative policy measures or packages that you would advocate? We are particularly interested any analysis you may have to support your views.

With respect to the gas market, the Gas Forum strongly urges Ofgem to retain its previous belief in the ability of a competitive gas market to deliver gas and infrastructure to the UK. This points towards packages at the left hand of Ofgem's diagram – targeted reforms and / or enhanced obligations, as well as proper consideration of the status quo. The Gas Forum does not dismiss the possibility that no change may be preferable to all five packages proposed by Ofgem. The Gas Forum is intending to carry out work to demonstrate that security of supply will be maintained in the UK by the effective operation of competitive markets.

Question 12: Do you agree with our assessment of the timing for important investment decisions?

The Gas Forum understands the analysis that concludes that there is a 2 year window in order for policy changes to be made. However, the Gas Forum considers there to be two further issues for Ofgem to consider -

- First, it is normally the case that change takes longer than expected by regulators. This points toward early resolution of the many options that Ofgem has put out for consultation.
- Second, the acceptance by Ofgem that there might be a negative effect on investment while Ofgem considers these options is somewhat concerning. Investment of the scale needed for the UK gas market cannot be switched on and off. It is possible that a slow down now will result in permanently delayed investment once it is clear what package is being preferred by Ofgem.

Question 13: Do you believe that early actions should be considered?

For the reasons set out above, the Gas Forum does consider early action should be considered. However, this would be a rapid ruling out by Ofgem of the more interventionist policies put out for consultation. The best course of action would be for Ofgem (and failing that, Government) to conclude that wide-ranging changes to the UK's competitive gas market are not being considered.

Question 14: Do you think that the issues are such that policy measures should be considered as a package or should they be considered on a case by case basis?

The Gas Forum considers that it is sensible to consider packages in a holistic way. However, many of the levers identified by Ofgem lie with Government or the European Commission. Since there is not – yet – any view as to whether there will be co-ordinated action, the Gas Forum considers that it may not be possible to conclude that a package – even if preferable – is deliverable.

The Gas Forum is particularly concerned that in fact Ofgem and Government have not co-ordinated even their analysis at this early stage. This is demonstrated by Treasury / DECC issuing their own energy markets assessment one week before the Ofgem consultation closes, with a markedly different conclusion as to security of supply. If the various authorities cannot even co-ordinate their consultation timetables, it does not bode well for a co-ordinated package of policy proposals being delivered.

Conclusion

As can be seen from this response, the Gas Forum has grave concerns about Ofgem's proposals, particularly the more extreme interventions, with respect to the gas market. While the Gas Forum welcomes the analysis undertaken by Ofgem, the Gas Forum is concerned that the scale of some of the intervention being envisaged by Ofgem will undermine the very investment that it is rightly pointing out is needed.

The Gas Forum considers that Ofgem and the Government should proceed rapidly to a conclusion that the competitive market will be relied upon to deliver the gas and infrastructure needed by the UK. The longer the uncertainty created by Ofgem's Discovery proposals, the more likely it is that investment will not be forthcoming.

The Gas Forum considers that there is a role for Ofgem, albeit not on the scale as envisaged by the Discovery proposals. We have identified four areas where Ofgem could usefully focus its considerable resources.

In the meantime if you wish to discuss our response further or need further clarity please do not hesitate to contact the Gas Forum on the number below.

The Gas Forum is content for this response to be published.

Yours sincerely



Franck Neel

Chairman of the Gas Forum