

Industry participants, customers and other interested parties

Promoting choice and value for all gas and electricity customers

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Dear colleague,

Gas Security of Supply Significant Code Review Launch Statement

Overview

This letter announces the launch of the Significant Code Review for Gas Security of Supply (the Gas SCR). It should be read in conjunction with the Initial Consultation Paper, also published on 11 January 2011.

The Code Governance Review (CGR) Final Proposals and the subsequent licence changes² introduced a new regulatory mechanism within the industry codes.³ The Significant Code Review (SCR) mechanism is designed to facilitate complex and significant changes to these codes. It provides a role for Ofgem to undertake a review of a code-based issue and play a leading role in facilitating code changes through the review process. This will enable us to avoid many of the inefficiencies and delays that have been associated with aspects of the standard code modifications process, thereby accelerating necessary industry reform.

On 12 August 2010, we published an open letter⁴ on our website inviting views on our proposals to commence three separate SCRs in 2011, as follows:

- 1) Electricity Cash-out
- 2) Gas Security of Supply
- 3) Smart Metering Impact on Wider Industry Processes.

In respect of Gas Security of Supply we stated that "Among various options, we intend to investigate the case for more dynamic cash-out prices (i.e. cash-out prices that are allowed to continue to move with market supply and demand) at stage 2 of a network gas supply

¹ The Initial Consultation document is available here:

http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/GasSCR/Documents1/Initial%20Consultation%20%20Gas%20Security%20of%20Supply%20Significant%20Code%20Review.pdf

² The final proposals and statutory licence changes are on the Ofgem website: http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx.

³ The industry codes affected are the Balancing and Settlement Code (BSC), the Connection and Use of System Code (CUSC) and the Uniform Network Code (UNC).

⁴ The open letter can be found here:

http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/SCR%20open%20letter%20consultation Aug10 final.pdf

emergency, as well as review the current compensation arrangements in place for firm load disconnection."⁵

A summary of responses to our proposal to launch the Gas SCR are summarised at appendix A. After considering these responses we have decided to commence the Gas SCR.

The Initial Consultation Paper provides further detail regarding our proposals. Our key objectives for this review are to enhance gas security of supply in an efficient manner. Specifically, we are seeking to:

- minimise the likelihood of an emergency occurring, by encouraging gas shippers/suppliers to take out sufficient 'insurance' (e.g. in the form of long-term contracts and storage capacity)
- minimise the severity and duration of a gas emergency if one were ever declared, by sharpening incentives to attract and purchase imported gas
- appropriately compensate firm customers (i.e. those who have not signed up to an interruptible contract) if they were ever to be interrupted.

Following the publication of the Initial Consultation Paper and this Launch Statement we are now entering into a six week period of consultation with stakeholders to seek views on the range of reform options we have identified.

Scope

The primary focus of this SCR will be the gas emergency cash-out arrangements⁶ although there may be other aspects of the current arrangements that will need to be considered.

Among the various options, we intend to investigate and consult on the following:

- the case for introducing dynamic cash-out prices in the event of a gas emergency to make these prices more reflective of market conditions,
- changes to the role of National Grid Gas (NGG) as system operator and the Network Emergency Coordinator (NEC), and
- compensation at the value of lost load (VoLL)⁷ for firm customers and are disconnected.

The emergency arrangements are set out in the Uniform Network Code (UNC), and any conclusions from the SCR are likely to involve modifications to this code. These conclusions could also lead to licence changes, for example around the role of NGG and the NEC.

We believe that reform of the emergency arrangements is likely to improve the incentives for shippers and suppliers to reduce the risk of a gas emergency occurring and to source gas in the event that an emergency occurs. However, we are aware that it is difficult to get these incentives right, and that there may be barriers that prevent market participants from responding appropriately. Therefore, there is a chance that these reforms may need to be supported by obligations on suppliers and/or the SO to deliver appropriate security of supply. We are seeking stakeholders' views on whether enhanced obligations could be effective in improving security of supply.

If we decide that obligations are required, these would likely be brought about through licence changes rather than through amendments to the UNC.

⁷ This is the value that consumers place on a secure supply of gas.

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⁵ That is, disconnection of supply of gas to those who have signed a non-interruptible contract.

⁶ Cash-out prices are, in effect, charges to shippers for being out of balance with their contracted position. That is, either taking more gas from the system than that which they put on or vica versa.

⁷ This is the system than that which they put on or vica versa.

Cash-out arrangements outside of an emergency are unlikely to be within the scope of the project. However, the option to address these arrangements following consultation with stakeholders will remain open.

To inform the SCR we will liaise as appropriate with bodies such as the Department of Energy and Climate Change (DECC), NGG, and the NEC. We will also work with the Health and Safety Executive (HSE) to ensure proper consideration of arrangements set out in documentation such as the NEC safety case.⁸

As stated in the CGR Final Proposals, we reserve the right to subsume any modification proposal that is raised during our review into the SCR if it is within or related to the scope of the review as set out above.

Reasons for launching the SCR

In the CGR Final Proposals we set out a number of circumstances that may trigger an SCR process. These include:

- developments in EU law or Government-led policy initiatives that have not otherwise been given full effect in legislation,
- a work stream internal to Ofgem,
- representations made by stakeholders (whether by code parties, code panels or other affected parties),
- code modifications proposed by industry, and/or
- unforeseen circumstances that appear to Ofgem to require us to consider the case for significant reform of one or more industry codes.

The Gas SCR has been triggered by a number of these events and we consider it to be timely in this respect.

The Gas SCR follows on from Ofgem's Project Discovery, which identified a number of concerns with the current gas emergency arrangements. As part of Project Discovery we set out a range of policy options for addressing these issues, some of which will be considered as part of the SCR. 10

DECC is supportive of our review of the measures in place to ensure security of supply in the gas market. In its Energy Bill of December 2010 (the Bill)¹¹, DECC is seeking to give Ofgem additional legislative powers to allow the Authority to direct modifications to the UNC if the Authority considers that such modifications will decrease the likelihood or severity of a gas supply emergency. This may allow measures to enhance gas security of supply to be implemented up to seven months earlier than the Gas SCR process would usually allow. The Bill is expected to gain royal assent before summer 2011, which would mean that the consultation performed as part of the Gas SCR could give the Authority sufficient justification to support the use of the new powers in the Bill. Subject to practical implementation issues, it is therefore possible that the reformed arrangements may be in place in time for winter 2011-12.¹²

In addition, the Gas SCR is being launched shortly after entry into force of the EU Gas Security of Supply Regulation. The Regulation entered into force on 2 December 2010 with the exception of certain parts which will apply from 3 March 2011. The Regulation provides the European Commission (EC) with additional powers, including powers to declare and be able to take certain actions in a regional or union emergency. The Regulation also imposes

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⁸ The NEC safety case is a confidential document which sets out the roles and responsibilities of the NEC in the event of a gas defecit emergency (GDE).

⁹ Project Discovery publications can be found on the Ofgem website: http://www.ofgem.gov.uk/Markets/WhlMkts/Discovery/Pages/ProjectDiscovery.aspx

¹⁰ More detail can be found in the Initial Consultation paper.

¹¹ The bill can be found here: http://www.decc.gov.uk/en/content/cms/legislation/energy_bill/energy_bill.aspx

¹² See the timeline for the Gas SCR at the end of this letter.

a number of requirements on the member state and the competent authority.¹³ For example:

- to ensure capacity to deliver total gas demand for levels of demand which are statistically exceeded no more than once in 20 years (1 in 20 year) in the event of disruption of the largest gas infrastructure
- to require natural gas undertakings to ensure supply to protected consumers for levels of demand occurring in a 1 in 20 year in the following conditions:
 - o extreme temperature during a seven day peak day period
 - o a period of at least 30 days of exceptionally high gas demand
 - a period of at least 30 days of the disruption of the largest infrastructure under average winter conditions.

There is also an obligation on the competent authority to put in place an emergency plan which clearly defines the roles and responsibilities of the various players involved in such an event.

The timing of the SCR will allow us to consider any measures which may need to be in place in order to meet these requirements.

Previous reforms to the gas emergency arrangements

We note that industry has previously attempted to reform the gas emergency arrangements to enhance security of supply. For instance, the Authority accepted modification proposal UNC 149A in October 2007. This modification opened the on-the-day commodity market in the event of announcement of stage 2 of a network gas supply emergency. A further modification (UNC 260) was accepted by the Authority in November 2009. This was aimed at improving the post-emergency claims arrangements for gas providers. These modifications are described in more detail in appendix 3 of the Initial Consultation Paper.

We recognise the incremental improvements brought about by these modifications. However, we anticipate that the SCR process will enable us to accelerate reform of the gas emergency arrangements as considered necessary to maintain security of gas supply.

In our decision letter on modification 149/149A we stated that `...we believe that there remains a strong need to revise further the gas emergency cash-out arrangements in light of GB's growing gas import dependence.' We also said that `...we would urge the industry to examine these issues in more detail and to bring forward further proposals that address the need to revise the current arrangements.'

In our decision letter on modification 260 we noted that `...a number of respondents have expressed concern at the piecemeal approach that has been taken to changing the gas emergency arrangements. We share the view that a wide ranging review of the arrangements is necessary as part of a broader review of security of supply in the GB market.'

As such, we consider that an SCR process is required to allow us to take the necessary coordinated approach to code modifications in this area. We believe that significant changes may be required to the existing relevant UNC provisions that have not been possible through the standard industry-led process.

In summary, the circumstances under which this SCR is being launched meet the relevant criteria for an SCR to be triggered as set out in the CGR Final Proposals.

http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC149D.pdf

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 $^{^{13}}$ The competent authority is the body that is responsible for compliance with the contents of the Regulation.

¹⁴ Our decision letter on mod 149 can be found here:

¹⁵ Our decision letter on mod 260 can be found here: http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC260D.pdf

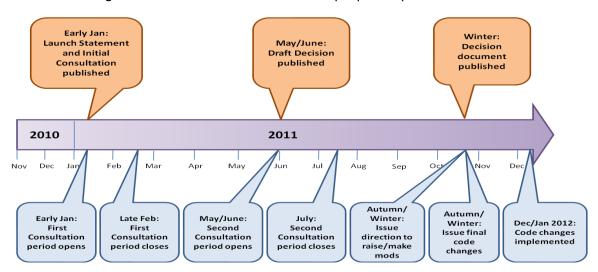
Reasons for using the SCR process

We do not believe that a review of this scope can be undertaken through the existing modifications process (or indeed the other processes introduced in the CGR Final Proposals). Through the SCR process we are able to raise the modification ourselves therefore allowing us to determine the scope of the review and manage the consultation process. This is of particular importance in considering our range of options which include dynamic cash-out, compensation at VoLL and the potential for enhanced obligations. In particular, the alternative processes would not allow us to conduct the wide-ranging review of the relevant UNC provisions which is envisaged for the SCR.

As set out above, we believe that the changes that need to be made to the UNC, the interactions between different areas of the UNC, the magnitude of the potential outcomes and the importance placed upon a review of the existing arrangements by DECC are all significant. Therefore, we believe that the SCR process is the most suitable vehicle for such a review.

Timeline of process

We set out a high-level indicative timeline of our proposed process below:



A qualitative impact assessment of the process is set out in appendix B. This provides guidance on the level of resources we anticipate could be required by interested parties feeding into the Gas SCR process. We also provide the terms of reference that we will adhere to in dealing with stakeholders throughout the process in appendix C.

Next Steps

We have published the Gas SCR Initial Consultation Paper alongside this letter and invite responses on the range of options presented. We will now be holding a set of consultation workshops as set out in table 1. We request that responses to the Initial Consultation document be sent to GB.Markets@ofgem.gov.uk by no later than 22 February 2011.

If you have any questions or comments on the content of this letter please contact Peter Sherry in the first instance (peter.sherry@ofgem.gov.uk).

Yours faithfully

Ian Marlee

Partner, GB Markets

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Appendix A. Summary of responses to the August 2010 open letter

On 12 August 2010, we published an open letter on our website inviting views on our proposals to run three SCRs including the Gas SCR. Of the 20 respondents to the open letter, 15 put forward a view on our proposal to run a Gas SCR. Around two-thirds of these responses supported some form of SCR in principle.¹⁶

Requirement for the Gas SCR

A number of respondents supported the Gas SCR in full given its timeliness in relation to the Government's view that the area needs attention. Many of those who showed support cited the potential to take a co-ordinated approach towards modifications in this area in contrast to the piecemeal developments resulting from the industry-led modifications process.

A few respondents argued that no evidence existed to suggest that current arrangements were inadequate and claimed that a Gas SCR could increase regulatory uncertainty. Some respondents believed that any identified modifications could be delivered through another process such as a UNC review group.

Others suggested that while there may be a need to review existing arrangements, the Gas SCR was less of a priority than the other SCRs. They argued that it should be delayed until a later stage in order to avoid the time and resource requirements of running three SCRs in one year.

Interactions with Electricity SCR

A number of respondents were keen to point out the potential interactions between the proposed SCRs for gas security of supply and electricity cash-out, and pressed the need to consider this throughout the Gas SCR process. One party suggested running the two SCRs as one at a later date given the inherent links between the two areas. In addition to coordinating any interactions, they suggested that this would alleviate some concerns around time and resource requirements.

Scope

Five respondents supported the Gas SCR to some degree but believed that it should have a wider scope. Some pointed to the fact that our proposals were targeting modifications to the UNC in isolation and cited the opportunity for a cross-code review which should be performed alongside bodies such as DECC and the HSE. In the absence of experience of a gas emergency, it was suggested that this could help industry to identify the merit of proposed modifications which was not possible through looking at the UNC in isolation.

Some also claimed that the scope of the SCR should be wider than market mechanisms alone. They suggested that reliance on price signals could lead to additional risk and complexity which could not be managed by the parties involved, and could result in the safety of the system being compromised. Rather, these parties pointed towards the use of other mechanisms such as statutory and licence obligations.

Respondents' views were mixed on whether non-emergency arrangements should be considered. One suggested that it was not necessary to review these arrangements as there was no evidence of any failure. Another said that they would welcome a more wide ranging review of cash-out arrangements if appropriate.

¹⁶ Responses to the open letter can be found at this link: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=336&refer=Licensing/IndCodes/CGR

Links with EU policy

Two respondents referred to interactions between the proposed Gas SCR and potential developments in Europe. One suggested that development of EU policy during the review could influence the direction of the SCR and affect time and resource requirements.

The other stated the belief that the focus of Ofgem should be on meeting the requirements of the Regulation and improving interconnected markets rather than the proposals put forward for an SCR.

Consumer benefits

The benefit for consumers as a result of an SCR process was cited as a reason for support by some. One respondent suggested that the debate surrounding compensation arrangements was long overdue. This respondent also highlighted the ongoing work on demand-side response concerning the scope and availability of interruptible contracts as being relevant to the SCR.

Our view on responses

Reasons for launching an SCR on gas security of supply

We agree with the majority of respondents' views that the SCR process will allow us to take a more coordinated approach towards making code modifications, and that the Gas SCR is timely given the relevant political developments both at the GB and EU level.

We recognise concerns regarding the amount of resource required. While the SCR will entail a level of commitment from Ofgem and stakeholders, we believe that this is merited in order to ensure that any resulting modifications enhance security of supply and avoid adverse impacts. We have attempted to mitigate the problem of resource requirement by starting the Gas SCR process before the other two proposed SCRs commence.

While we are aware of the views of some respondents who suggest that in the absence of an emergency occurring there can be no evidence that the current arrangements are failing, we do not feel that the existing arrangements are fit for purpose, in particular given the move of GB from a net exporter to a net importer of gas. Previous modifications have gone some way to improving these arrangements but have not alleviated all of our concerns. We therefore deem a Gas SCR necessary in order to conduct a wide ranging review of the arrangements and make any changes to the UNC as necessary.

We agree with those respondents who suggest that the SCR could lead to significant benefits for consumers. In addition to the possibility of reducing the risk of disconnection below the level at which customers value security of their gas supply, our review will also consider compensation arrangements. This may lead to compensation set at a determined measure of VoLL in the event that firm customers are disconnected.

Scope of the SCR

We agree with those respondents who suggest that the SCR team need to work closely with bodies such as DECC and the Energy Emergency Executive Committee (E3C) for the emerging arrangements to be as well considered and effective as possible. We intend to meet with these bodies on a regular basis as we develop our proposals. We also agree that attention needs to be paid to the Regulation and EU law developments more generally. Rather than considering that these should take precedent over an SCR we feel that the SCR is timely in that the requirements of the Regulation can be incorporated into our proposals as they are developed.

We recognise the need to consider other options (in particular obligations) in addition to market mechanisms. Alongside our review of emergency cash-out arrangements we will

investigate the case for supplier obligations to improve supply security. Work performed on the SCR may lead us to conclude that enhanced obligations are required in some form.

Appendix B. Impact assessment

Internal resource

There will be an in-house team working on the SCR with input from other teams across the organisation. Where additional expertise or resource is required, we may seek to engage external consultants.

If appropriate, required modifications (including legal drafting) will be handed over to NGG at the end of the process for implementation under a time bound licence condition.

Expectations of industry resource requirements

In order to develop our proposals we will welcome input in the following ways:

- reading and providing comment on key documents throughout the process
- attendance at stakeholder events
- providing input into the consultation processes
- giving any other comment regarding the process or proposals.

We would expect each party involved to assign at least one member of staff towards keeping track of developments and engaging with the Gas SCR team at Ofgem.

We will be inviting stakeholders to attend a number of consultation events to be held as part of the Gas SCR process. In addition, we will be inviting some stakeholders to join a number of focussed workshops in order to develop the detail of our proposals. We request that the same individual from each party who is invited to join these focussed workshops attends wherever possible.

Table 1 outlines where we would welcome contributions from stakeholders. Note that we intend to communicate with stakeholders on an ongoing basis and that input may also be provided or requested outside of these main events.

Table 1: Input required from industry

Total Carpet required from markety			
Event	Date	Input required	Party responsible
SCR launch consultation	Jan – Feb 2011 (six weeks)	 Review papers Attend 2 stakeholder seminars Select attendance at 3 focus workshops Submit responses 	All stakeholders
Initial proposals consultation	Jun – Jul 2011 (six weeks)	 Review papers Attend stakeholder seminars Select attendance at focus workshops Submit responses 	All stakeholders
Legal drafting workshops	Jul – Oct 2011	Review papersSelect attendance at focus workshops	All relevant stakeholders
Implementation of changes	Autumn 2011 – Winter 2011-12*	Amend UNCUpdate systems	NGG/ xoserve (predominantly)

^{*}Timing dependent on whether further industry process is required, whether new legislation can be enacted to allow Ofgem to direct a modification and the amount of time required to implement or modify the relevant processes and systems.

Appendix C. Engagement with stakeholders

The issues to be addressed by the Gas SCR are important and complex. If the review is to be successful, we need to draw on the expertise of a range of stakeholders. We have put in place a number of channels whereby stakeholders can engage with us.

- Consultation documents: We intend to publish two consultation documents and a
 Decision document. These will provide an update on our thinking and allow
 interested parties to express their views formally.
- **Stakeholder seminars:** We intend to engage with interested parties through a number of stakeholder seminars, both after the release of this Launch Statement and the Initial Consultation Paper and following the release of our Draft Decision document. These seminars are intended to engage all relevant stakeholders and present the content of our consultation documents and emerging thinking.
- Workshops: We are also proposing to run a number of workshops to develop thinking on specific issues during 2011. The workshop groups will meet during consultation periods to discuss some of the detailed issues under consideration.

Key points to note with respect to the stakeholder seminars and workshops include:

- Stakeholder seminars will be open to all interested parties. We would expect to hold seminars both immediately following a release of a consultation paper, as well as after the completion of a series of workshop meetings.
- Attendance at the workshops will be at the invitation of Ofgem and will be limited to a number which will allow for round-table discussions selected by invite. Ofgem will chair these meetings.
- We expect to hold around six workshops over the course of the Gas SCR.
- We would ask that, wherever possible, the same participant from each of the parties involved attends the workshop meetings and is responsible for communication with the Gas SCR team at Ofgem.

- Teleconferencing facilities should be available at all meetings for those members who are unable to attend in person.
- Where we require members of the group to read material in preparation for the workshop meetings, we will use our best endeavours to circulate these no later than two working days before the date of the meeting.
- While the workshops should provide the primary medium for ongoing communication, we will also accept comments which are made outside of these events. We will continue to engage at the various stakeholder groups held on a regular basis.

We will be assessing and communicating the expected impact of our proposals on an ongoing basis throughout the SCR process while inviting comment from stakeholders on whether they agree with our assessment.

If for any reason our original timetable slips from that indicated above we will seek to publish the reasons for this alongside a revised indicative timetable. The revised timetable should highlight when we anticipate publishing the Draft Decision and Decision documents.

We have launched a Gas SCR section on our website where stakeholders can access relevant documents.¹⁷

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¹⁷ The Gas SCR webpage can be found here: https://ofgem.gov.uk/Markets/WhlMkts/CompandEff/GasEmerg/GasSCR/Pages/GasSCR.aspx