ofgem

Minutes

Gas SCR: Workshop 3 – Obligations and the impact assessment criteria

Date:	Friday 4 February 2011
Time:	10:00 – 13:00
Location:	Room 9, Ofgem offices, 9 Millbank, Westminster

1. Attendees

1.1. A list of attendees is contained in attachment 1.

2. Introduction
Peter Sherry, Senior Economist, Ofgem

2.1. Peter welcomed attendees and thanked them for their attendance. He noted the importance of the workshops and stakeholder engagement more generally. Peter reminded attendees that the closing seminar would be held the following Wednesday (9 February) and there would be a number of opportunities for further consultation after this time.

2.2. Peter then ran through the agenda for the day. The workshop was to start with a discussion on the case for obligations, who obligations could apply to and what the obligations could be for — to be lead by Jamie Black (Economist, Ofgem). After a short break the discussion would then turn to the criteria to be included in the impact assessment — to be lead by Andrew Pester (Senior Economist, Ofgem).

3. Obligations

3.1. Jamie Black started by noting that there are a number of reasons why obligations might be chosen rather than relying on market signals to ensure appropriate investment is undertaken to improve security of supply. These reasons were discussed in the initial consultation and include:

- Because gas emergency deficits are high impact low probability events, market participants may not be able to adequately judge how to insure against these events occurring.
- If the fall out from an emergency cannot be targeted on the market participants responsible for the emergency, there could be problems of underinsurance by some parties that are free-riding on the insurance of others.
- Even if there were appropriate incentives to invest against an emergency occurring, there may not be enough gas available to be attracted to GB at any price and hence, price signals may not be effective.
- There could be public good characteristics of having a secure gas supply such that obligations might be worth pursuing (i.e. the costs of an emergency could be so detrimental to the GB economy that obligations should be used to ensure this never occurs).

Monitoring of obligations as compared to price signals

3.2. One of the attendees noted that obligations may be easier to monitor and prove (in terms of achieving security of supply outcomes) than price signals. It was noted that this could be one advantage of obligations.

3.3. Ofgem staff noted that monitoring the effectiveness of price signals in delivering security of supply would be difficult without being able to prove counterfactual and indeed, there would have to be an element of trusting in the market to deliver.

3.4. One attendee noted that by articulating an obligation, this will make it easier to achieve the security of supply levels that are being targeted. It was noted that industry can plan for these events and demonstrate that they have undertaken adequate planning to meet their obligations.

Public Service Obligations in some European countries

3.5. One attendee questioned whether GB will be able to attract gas in an emergency using price signals but that they were not sure that obligations were the answer either. In particular, the divergence of arrangements between GB and other interconnected markets was spoken about as a potential barrier to attracting gas supplies.

3.6. It was noted that a number of European countries have Public Service Obligations (PSOs) regarding gas. An attendee stated that Ofgem has previously criticised the use of PSOs for this and that as obligations are quite similar to PSOs, this would seem to be counter to previous opinions voiced by Ofgem.

3.7. Another attendee argued that it depended on the type of obligation. This person also noted that PSOs and obligations are very powerful and will override price considerations.

3.8. One attendee noted that by articulating an obligation, this will make it easier to achieve the security of supply levels that are being targeted. It was noted that industry can plan for these events and demonstrate that they have undertaken adequate planning to meet their obligations.

What level of security of supply do we want?

3.9. One participant noted that interruptible contracts can be used to some extent to curb demand but questioned the level of security of supply that we are aiming for.

3.10. Another attendee noted that National Grid Gas (NGG) plans for a 1 in 50 winter. The question was asked about whether this was the right level of security of supply or whether a 1 in 20 winter would be more appropriate, for example.

3.11. It was noted that delivering any level of security of supply should be weighed up against the costs of providing that level of security of supply. For example, you could aim to meet demands for 99 winters in 100 but the cost of this would be likely to be prohibitive.

3.12. It was noted that for shippers, a 1 in 50 winter goal for security of supply is relatively meaningless. Shippers instead focus on their core business which is to keep buying gas and balancing their supply regardless of the price.

3.13. Later, a participant asked whether we currently have information on whether the GB gas market is expected to meet firm demand if 70 million cubic meters came offline. Another attendee stated that it was predicted that all priority users' demand would be met but that this doesn't cover all firm customers' demand.

Are there reasons why price signals won't work?

3.14. Ofgem staff asked whether there is any evidence that price signals will not deliver greater levels of security of supply.

3.15. One participant argued that more storage and greater demand side response (DSR) was required. Another stated the importance of ensuring we never get into an emergency.

3.16. As was suggested in the second workshop, having an extra stage in an emergency where daily metered customers could be asked to voluntarily be interrupted prior to an emergency being declared was given further support.

3.17. One attendee noted that having a dynamic cash-out price might not be much of an improvement from the current situation as it is still frozen but instead everyone knows what price is will be frozen at (i.e. VoLL). As such, it was argued that the current arrangements already provide commercial incentives to balance.

3.18. Another attendee noted that if the purpose of the review is to introduce measures to improve investment in storage there are other things Ofgem should be considering. In particular, the government could improve incentives for industry to build extra storage. This attendee was of the belief that price signals during an emergency would not result in extra investment in storage outside of an emergency.

Are there any market distortions from introducing a buffer?

3.19. Ofgem staff asked attendees whether the introduction of a mandatory supply buffer would cause distortions to the market.

3.20. One participant put forward the view that a buffer that was achieved through DSR would not distort the market. Another noted that it could be legitimate to reduce demand instead of increasing storage and supply. However, another noted that DSR is more difficult to prove as effective in improving security of supply compared to proving access to physical gas supplies. To counter this it was noted that the Health and Safety Executive (HSE) saw DSR as a legitimate response to dealing with a supply imbalance.

3.21. Later, when discussing storage obligations in more detail it was mentioned that such obligations would have a negative impact on liquidity if excess gas were being held in storage over long time horizons. There was some consensus that holding storage indefinitely to safeguard against an emergency occurring was quite inefficient.

3.22. One attendee suggested also that if GB were to hold more strategic storage than the rest of Europe this could be directed to Europe in times where there was a cross-Europe emergency at a cist to the GB market.

3.23. It was also noted that obligations were likely to be an expensive way of improving security of supplies and that this additional cost would ultimately fall on consumers.

General design issues

3.24. It was questioned how an obligation could be implemented and how it would be policed. Attendees also asked whether an obligation would be on physical gas or whether it could apply to national balancing point (NBP) trades.

3.25. One attendee noted that most small suppliers rely on NBP and could not meet obligations concerning physical gas.

3.26. Other attendees questioned how an obligation could be designed to allow those subject to the obligation flexibility in how to meet it. It was noted that this would be difficult to monitor for compliance.

3.27. Ofgem staff noted that Ofgem had been collecting some information on winter outlooks for gas supplies on a voluntary basis. However it noted that this provided little

useful information due to the various forms in which the information was submitted. It was noted that this is relevant to how Ofgem would monitor compliance with an obligation.

3.28. One participant distinguished between physical as compared to price risk in an emergency. Another noted that there are many financial products to deal with price risk but that there is not necessarily anything available to deal with supply risk. For example, this participant argued that the 1 in 20 obligation on transporters was not well understood. One attendee suggested that xoserve could provide some useful information.

3.29. Later, an attendee asked whether obligations would appear in the Uniform Network Code or in licences. Ofgem staff replied that this would require licence changes.

Should obligations be on shippers or the system operator?

3.30. Ofgem staff asked for participant views on whether (assuming obligations were deemed necessary and ignoring the other design issues associated with obligations) obligations would be better placed with shippers or with the system operator (SO).

3.31. One attendee noted that in terms of DSR in an emergency there was a general view that customers would rather contract with the SO rather than their supplier.

3.32. Another attendee argued that the ultimate obligation should rest with the SO. Shippers could also have obligations but the ultimate obligation would be on the SO.

3.33. One attendee noted that there could be some short term obligations on shippers (i.e. regarding processes to be followed in an emergency) that could tie into the SO's obligations.

3.34. The issue of who would pay for the cost of having obligations the SO was raised.

3.35. The extra stage of an emergency that was proposed in workshop 2 was discussed as an obligation on the SO. It was noted that allowing prices to respond to the market in this stage could allow for peakier levels of cash-out prior to an emergency. It was also noted that in fact, cash-out could decrease once firm customers were voluntarily interrupted in this new stage.

3.36. It was noted that customers would only participate in this voluntary stage to get compensation and to try to protect the rest of their supply from involuntary interruption. The success of this stage was generally viewed as dependant on the contracts being with the SO rather than the supplier.

Could the value of lost load be used to inform the appropriate level of security of supply?

3.37. Ofgem staff asked whether there was a role for the value of lost load (VoLL) in informing what the target level of security of supply should be.

3.38. One attendee noted that customers have shown themselves to have difficulties in estimating their VoLL. This attendee asked to hear views from a consumer representative at the closing seminar or at a later workshop.

3.39. It was noted that some industrial customers might actually have a VoLL in excess of domestic customers' VoLL.

Top up

3.40. The old 'top up' scheme was discussed. One of the attendees gave an overview of the scheme noting that the SO made forward predictions for how much gas would be required for a 1 in 50 winter given current demands and supplies. The SO would then top up the amount held in storage for this if storage levels fell below certain pre-determined levels throughout the winter.

3.41. An attendee questioned the cost of top up. In response, the first attendee noted that top up was never actually breached while in place. However, top up was ultimately removed as the expected costs of running the scheme over the 2004/05 winter were estimated to be around £200 million. It was also noted that top up dulled the incentives on shippers to ensure security of supply as this role was provided by the SO.

3.42. It was also noted that there was a problem of shippers withdrawing their supplies in storage as the storage level approached the top up line.

3.43. One attendee noted that we now have a highly diversified gas supply and questioned the need for obligations. Another attendee noted that changes to the interruptible contracts regime have reduced DSR to mitigate an emergency.

3.44. It was questioned whether top up should be reintroduced. One attendee noted that it appeared to be a distortionary mechanism. However, another noted that while distortionary, it might be better than some of the other options for improving security of supply.

3.45. One attendee argued that if the government wants certainty about security of supply, building extra storage would be the best way to achieve this. This attendee then stated than the government had a preference for more storage. However, this point was countered by another attendee.

An obligation to diversify

3.46. Ofgem staff asked whether there was a way in which obligations could be designed to allow industry participants flexibility in meeting them.

3.47. One attendee suggested that there could be an obligation on shippers to diversify their supply. Another suggested that the NBP already provides this. One participant suggested that many shippers already have highly diversified supply. Another participant countered that some shippers 'piggyback' on the diversified strategies of others but do not diversify themselves.

3.48. Another attendee stated that small players are not able to diversify and only the big 6 are able to diversify. Hence, if there was an obligation to diversify this would be very bad for small shippers. In response to this, another attendee suggested that an obligation of this type would be bad for competition and liquidity.

3.49. It was noted by another attendee that if there was an obligation to prove physical gas supplies, this would have a negative impact on the NBP. This attendee then stated that the NBP is important in providing signals to encourage investment.

3.50. The fact that GB is one of the most liquid gas markets in the world was noted. It was suggested that reduced liquidity in the gas market would be a perverse outcome.

4. Impact assessment criteria

4.1. After a short break, Peter introduced the session on the impact assessment (IA) criteria. The discussion for this session was led by Andrew Pester (Senior Economist, Ofgem).

4.2. Andrew noted the importance of the IA in terms of understanding the various costs and benefits of the options being discussed.

4.3. One attendee questioned whether Ofgem was going to undertake an IA on the preferred option alone or on more than one option. Ofgem staff responded that a number of options would be included in the IA as this would be part of the process for determining the preferred option.

Impact on consumers

4.4. Another attendee noted the importance of breaking down the costs to consumers and in particular, different types of consumers.

4.5. There was support for getting the views of consumers through a consumer panel. Especially in respect of consumers' willingness to pay for additional security of supply and willingness to accept for compensation.

4.6. In respect of consumers, one attendee noted that there is likely to be a transfer of benefit from some consumer groups to others (i.e. to the extent that I&C customers take part in DSR, the main benefit from this will be for domestic consumers).

4.7. In speaking about this, an attendee noted the importance of defining security of supply in undertaking the IA. In response to this another attendee questioned whether domestic customers have a clear concept of what security of supply is. To this, it was suggested that those customers that have had their gas supply interrupted might have a better understanding of what it means to be cut off.

4.8. Again, it was suggested that a survey of customers that have and have not experienced interruptions would be useful for determining what customers want in terms of security of supply.

4.9. Later, attendees asked whether consumers want compensation. Another noted that compensation is not required for customers under and EU directives.

4.10. The impact of smart meters and the ability of domestic customers to engage in DSR was discussed briefly.

Barriers to entry, credit impacts and liquidity

4.11. Ofgem asked participants to think about how certain things such as barriers to entry, credit implications and liquidity could possibly be quantified.

4.12. One attendee suggested that the cost of bringing in extra gas could be assessed as an indication of credit implications. However, another attendee countered that this might not be relevant if gas is not attracted to GB due to PSOs in European countries.

4.13. Another suggested that the cost of replacing the gas held within a certain piece of infrastructure could be estimated to assess the cost of that infrastructure failing.

4.14. One a different track, one attendee suggested that qualitatively, compensation would be a liability for shippers and would likely create a barrier to entry. However, this would depend on who was liable for paying the compensation. It was suggested

that if targeted, compensation could bring a shipper into financial distress. However, if socialised, this could dampen incentives on shippers. In addition, if large enough, compensation liabilities could affect the whole industry.

4.15. One attendee asked whether compensation was capped for electricity. Another attendee answered that it was.

4.16. In regards to compensation, some attendees noted that there could be perverse outcomes for investment if companies were saving money to pay out any potential compensation liability rather than using that money for investing. It was also noted that some shippers could be 'hit twice' if they do invest in greater security of supply but also end up being liable for compensation.

4.17. In response to this discussion, one attendee noted that capping compensation could help in allowing shippers to understand their potential liability which would allow them to assess how to deal with this liability.

Safety impacts

4.18. One attendee noted that it is very important that any option for reform is feasible from a health and safety perspective. To ensure that the HSE is able to approve the safety case, it is important that the respective parties are able to do the things that are required of them.

4.19. On this point, it was noted that the speed at which things can happen will also be important in assessing the options.

Other issues

4.20. Interactions between the incentives provided by cash-out outside of an emergency and how these could change depending on the option implemented were discussed.

4.21. One attendee questioned how costs would be recovered if obligations were placed on the SO.

4.22. One attendee noted that the level of VoLL will have impacts for the IA.

4.23. Another attendee noted that the costs to distribution network companies if an emergency ever occurred would be significant and should also be considered as part of the IA.

5. Thoughts from attendees at the end of the first series of workshops

5.1. After discussing the IA, Peter invited each of the attendees to state what their initial thoughts are now that the end of the first series of workshops was coming to a close. The main themes from this are summarised below (in no particular order):

- The Gas SCR should not result in a move away from the effective gas market that GB currently has (in particular, the introduction of PSOs).
- There needs to be careful consideration of the potential costs to consumers. It is likely that all options will increase costs for consumers.
- Capping cash-out at VoLL might not help to improve security of supply compared to the current arrangements.

- Compensation could be beneficial but only if consumers want it. Perhaps customers could choose whether to have compensation.
- There should be no compensation for domestic customers.
- Compensation should be capped.
- There is a need for a bigger 'buffer' to ensure security of supply.
- DSR could be a good way to improve security of supply. However, how can customers be incentivised to participate in DSR?
- It could be difficult to determine what level of security of supply we should have. Moreover, it is unclear what level of security of supply we currently have. It could also be difficult to demonstrate that any reform has achieved a higher level of security of supply.
- There could be a case for having different arrangements for a slow emergency as compared to a fast emergency.
- There could be transporter capacity issues that impact on the ability to restore reconnection after an emergency.
- There could be lessons from top up and other options that have been considered in the past.
- It is unclear that any of the options in the initial consultation document would increase investment to improve security of supply.
- It is unclear whether there is a problem that needs fixing.
- The impact of any changes on the electricity market should be considered.
- Investment in more storage would ensure that GB never gets into an emergency. There are a number of reasons why there has not been greater investment in storage.
- Option 1 in the initial consultation may not meet safety case requirements.
- A new pre-emergency alert would be beneficial.
- The best option for reform could be some combination of the options put forward in the initial consultation document.
- Prevention is better than cure — the arrangements should, as much as possible, ensure GB never experiences a gas deficit emergency.
- Only small improvements in security of supply are required.
- The National Emergency Coordinator (NEC) should retain the power to instruct gas flows.
- Obligations for long term contracts would have adverse outcomes for the gas market.
- Obligations for storage would probably improve security of supply but would be costly.

Attachment 1 — list of attendees

Alison Meldrum	Tata Steel
Amrik Bal	Shell Energy Europe Ltd
Andrew Pester	Ofgem
Anna Barker	Ofgem
Anna Saksonov	Ofgem
Chris Wright	Centrica
Dora Ianora	Ofgem
Eddie Proffitt	Major Energy Users Council
Giles Stevens	Ofgem
Ian Trickle	ExxonMobil
Jamie Black	Ofgem
Jeff Chandler	SSE
Jenny Phillips	National Emergency Coordinator (National Grid)
Jill Brown	RWE npower
John Costa	EDF Energy
Julie Cox	Association of Electricity Producers
Laone Roscorla	Cornwall Energy
Lewis Heather	Ofgem
Malcolm Arthur	National Grid
Mark Dalton	BG Group
Peter Sherry	Ofgem
Richard Fairholme	E.ON
Richard Street	Corona Energy
Ritchard Hewitt	National Grid
Roddy Monroe	Centrica Storage
Shelley Rouse	Statoil (UK) Ltd
Steve Gordon	Scottish Power