bp

Antonio Ciavolella
European Regulatory Affairs
Gas Trading Europe and LNG

BP Gas Marketing
20 Canada Square
Canary Wharf
London
E14 5NJ

22 February 2011
Peter Sherry
Senior Economist, GB Markets
Ofgem
9 Millbank
London, SW1P 3GE

Direct: +44 (0)20 7948 5147
Main: +44 (0)20 7948 4000
Mobile: +44 (0)78 2528 3854
Fax: +44 (0)20 7948 7844
Email: antonio.ciavolella@bp.com

Subject: Gas Security of Supply Significant Code Review (SCR) Initial Consultation

Dear Peter,

Thank you for the opportunity to respond to the consultation document on Gas Security of Supply Significant Code Review (SCR). BP has non-confidential comments on both procedural and substantial aspects, which we can summarize in the following statements:

- The diversity of events generating emergencies require a wider and more strategic approach than a review of the emergency cash outs
- The diversity of actors impacting supply security require a more coordinated and simultaneous comparison of current options with alternative measures focused on demand and network incentives
- The importance of the matter, the complexity of the issue and the distance from the day-to-day business require a more transparent and inclusive regulatory process to inform and allow stakeholders participation

General Comments

BP welcomes the opportunity to contribute to this important debate. We agree that Security of Supply (Security of Supply) is a central goal of energy policy, which is delivered through a very long term planning and decision making horizon. We also agree with Ofgem that interventions to improve SoS shall aim at reducing the likeliness of emergency arising, rather than focusing on how to handle it. Moreover, we understand that SoS is a very complex issue, with emergency situations possibly originating both in supply, network, and demand, developing at varying degree of speed, as well as spreading locally or nationally with a varying degree of gravity.

In light of these remarks we express doubts as to the evidence and concepts underpinning Ofgem SCR proposals. In addition, we are concerned by the procedure Ofgem followed to complete this initial stage of the SCR process.

BP Gas Marketing Ltd
Registered in England and Wales No. 908982
Registered Office:
Chertsey Road
Sunbury on Thames
Middlesex
TW16 7BP

We do acknowledge GB has become a net importer of gas and that the international Geopolitical context has changed. Nonetheless in these last years we witnessed a consolidation of high liquidity and low volatility levels, and the industry prevented an emergency from being declared even in the most critical situations, such as the collapse of Enron, Rough outages, interruption of Russian supplies to the continent, and unusually cold winters. BP believes solid market arrangements have fundamentally contributed to achieve this remarkable result, by providing additional interconnection, peak storage and LNG facilities. We find this view over market fundamentals reflected in many respected sources of analysis, such as IEA's latest World Energy Outlook[1] and recent work on gas SoS by leading GB consultancies such as Poyry. We would have therefore expected Ofgem to focus more on incremental enhancements of market functioning which promote secure supplies, rather than cash outs to handle supply disruption.

As to the conceptual foundation, Bp considers the current set of options is too narrow to address the variety of events which can potentially generate an emergency. Considering the wide range of events which can generate a gas deficit emergency, we would have expected Ofgem to undertake a much wider and comprehensive review of emergency arrangements.

Finally, we found procedural arrangements disappointing in terms of accessibility, opportunities for interaction and transparency. For instance, the workshops minutes provided poor coverage of discussions and referred to comments anonymously. Also, we consider that three weeks was an inappropriate timing to understand in depth the proposals and the issues at stake. Considering SoS importance, we would have expected Ofgem to undertake a SCR process with no restrictions to workshop participation, greater opportunities to interact, and greater transparency. We therefore take the opportunity to firmly invite Ofgem to review arrangements for the next stages, in order to achieve a more inclusive and transparent process.

In summary, we believe that current arrangements have performed significantly well in terms of supply security. We do think regulatory efforts shall focus on incremental improvements which refine market design, and improve network reliability incentives and demand response flexibility. Finally, we believe that Ofgem shall review the current regulatory process to achieve greater participation, inclusiveness and transparency for all stakeholders.

Answers to specific questions

CHAPTER 3

Question 1: Have we captured the appropriate range of options for reform of the gas emergency arrangements? Are there other options that should be considered?

BP believes that Ofgem shall place greater focus on generating options which prevent emergency from occurring. We believe that focusing on cash outs and VOLL is narrow in comparison to the variety of events which potentially generate a gas emergency. Similarly, we consider that Ofgem focus shall be rebalanced to address comprehensively and in a coordinated manner the role of networks and demand on SoS. In other words, we would place greater attention on indirect measures enhancing market functioning, on testing a wider range of SoS drivers, and on providing good incentives to all players contributing to it.

BP believes that market arrangements have proved their effectiveness in delivering secure supplies. As we see no immediate threat for GB energy supplies, we therefore believe that incremental enhancements are the most effective way forward for a long term response to the changing market environment. This is best exemplified by initiatives such as the review of imbalance charges for when NGG does not operate on the OCM[2].

[1] International Energy Agency, *World Energy Outlook 2010*, OECD, 2010

[2] Uniform Network Code Modification 0333: review of the SMP Buy and Sell price.

We then feel that further options shall originate from a more comprehensive and coordinated review of emergency arrangements. We would expect Ofgem to analyze and compare simultaneously the effectiveness of alternative measures leveraging on demand, supply and network players. For instance, we would have appreciated prospecting a direct comparison of current proposals with enhanced networks reliability incentives, given that many recent supply disruptions originated in infrastructure. Similarly, we would have considered beneficial reconsidering and comparing current options with the reconsidering the interruption regime operating from 2012, given the doubts that the industry expressed on the effectiveness of such new arrangement.

Question 2: Of the three options presented, which do you prefer? Why?

As stated above, we believe diverse emergency situations require tailored plans and approaches. In our view, a "one size fits all" approach can at best contribute to resolving some types of emergency, but at worst can be detrimental to GB market efficiency. For example a slow build-up over a sustained cold period could be resolved by increased imports via pipeline and LNG, as long as the economic signals are allowed to function properly. In this situation, UK prices will reflect European and world markets, and suggest that an increase in price will still have a volume response. In contrast, if there is a sudden interruption for example of a significant piece of infrastructure, then only a limited response may be possible in a short period. Subsequent price increases would not encourage further response without exposing those with short positions to unstable prices. Under these circumstances, some freezing or capping of cash out prices would be appropriate.

In light of these remarks and of the focus on emergency arrangements, we are in a better position to exclude the dynamic cash out pricing as the least beneficial option Ofgem proposed. We deem the concept of emergency incompatible with the concept of dynamic cash outs. We would expect a dynamic cash outs emergency regime to work effectively under properly functioning market arrangements. However, if the market is functioning properly, we would see no net benefits in declaring an emergency. Also, dynamic cash outs would create strong tensions on credit requirements. Our experience is that bank guarantees become more expensive as their marginal exposure to the whole industry increases. We believe this would at best impose unnecessary costs on final customers, while at worst these arrangements could be detrimental to liquidity, number of players and gas volumes traded in the GB market.

Question 3: What is the appropriate role for NGG in an emergency?

BP believes that NGG current role shall stay the same.

Question 4: Do you have any comments on our initial assessment of the pros and cons associated with each option?

We have no additional comments to make.

Question 5: Are there any safety case implications associated with each option?

We have not comment on this aspect.

Question 6: What benefits would dynamic cash-out bring relative to the post emergency claims arrangements?

BP believes the industry is not in a position to make informed comments on Post Emergency Claims (PEC). However, we are not persuaded that dynamic cash outs would out perform them, as both could potentially lead to increased disputes, particularly where extreme prices could breach credit arrangements.

CHAPTER 4

Question 1: Are there any reasons why industry might not respond adequately to sharper price signals, thus delivering sub-optimal security of supply? How could these be overcome?

BP agrees with Ofgem that there are several drivers which might reduce the capacity of industry to respond to sharper price signals. In this sense BP believes effective market design and its continuous enhancement is the ultimate driver of long term liquidity performance. As stated above, we think that by taking a more comprehensive and strategic approach, Ofgem is in a position to address or influence some of the drivers that would make market functioning more effective in terms of secure supplies.

Nevertheless, at the extremes of demand and supply ranges there is limited capability for suppliers and consumers to respond to price signals dynamically. The question becomes one of whether the risk of supply failure incentivises incremental investments in storage that will only be used in low-probability high-impact events. Reduction in demand for capacity at onshore LNG storage sites would suggest that this may not happen to the extent that Ofgem might wish to see. If Ofgem desires a higher level of security than the market is willing to provide, other measures with non clear cut economic benefit may need to be considered (e.g. the return of top-up, capacity markets for storage).

Question 2: What are the likely barriers to attracting gas imports during a GDE? Could these barriers be overcome?

BP believes there are regulatory and infrastructural drivers which limit the amount of gas available from and to the continent. We consider Public Service Obligations and the existence of Long Term Contracts as the two most significant ones.

Our experience is that Public Service Obligations reduce the possibility to send gas to the GB when prices signal arbitrage opportunities. Similarly we understand that Long Term Contracts generated inefficiency in using the IUK interconnector.

Additional interconnection and LNG capacity provided extra flexibility during recent peak demand years. However we do understand that current arrangements could still pose some challenges to free flows of gas between GB and the rest of Europe. Specifically, BP believes Ofgem could have an opportunity to influence continental countries and further alleviate Third Package implementation as a window for further progressing flexibility to and from the continent.

On a positive side, increased global trading capability in LNG should help, though response times cannot be immediate.

Question 3: Do you think that the risks associated with sharpening price signals make it necessary to apply additional obligations on relevant parties?

There would be a concern that additional obligations might interfere with the operation of the market. As far as possible, obligations should be commercial and market-based.

Question 4: If enhanced obligations were applied, to whom should they be applied and why?

Not applicable.

Question 5: How could obligations be designed and enforced?

We are not in a position to answer this question.

Question 6: What are the risks and potential unintended consequences associated with placing enhanced obligations on parties to ensure security of supply? Can these be overcome?

BP experience is that current competitive climate has generated a constant endeavour to improve efficiency and effectiveness and to tailor gas supply service to the specific needs of customers. We therefore believe that the risk of imposing standardized obligations on all suppliers and shippers could lead to relatively ineffective solutions, and to unjustified cross payments across categories of customers.

We see the prospects of standardized obligations could translate into both higher customer bills and in the longer term, to reduced liquidity due to crowding out of smaller and less financially solid energy shippers.

We are therefore not persuaded by strong enhanced obligations in a top down fashion. Our experience is that commercially negotiated arrangements would better serve the purpose of tailoring payments to the willingness to pay of customers.

CHAPTER 5

Question 1: Have we captured the feasible range of costs and benefits for inclusion in an impact assessment?

We are not in a position to answer this question.

CHAPTER 6

Question 1: Would it be appropriate to have multiple administrative VoLL settings for different customer groups? Why/ why not? How are VoLL estimates likely to vary between customer groups?

Question 2: For a customer group, how should we determine where in the range of estimates (i.e. VoLLmax, VoLLaverage or VoLLmin) we should apply a single administrative VoLL setting?

Question 3: Should the compensation payments to disconnected firm customers (based on VoLL) change with the duration of the interruption and the season in which the interruption occurs?

Question 4: What are the advantages and disadvantages of various methods for estimating VoLL?

Question 5: What sort of compensation arrangements should be used to apportion the costs of compensation between shippers?

Answer to questions 1-5

While BP does not operate a supply business, we believe there are both conceptual and methodological issues which make VOLL at best very complicated to implement and at worst having major distortions in the market.

VOLL varies across time and across categories of customers. In addition, we understand VOLL varies for additional marginal quantities of gas disrupted. The industry has come across these limitations by negotiating contracts and interruption arrangements which have produced effective proxies for VOLL.

We believe that any type of predetermined value would have detrimental effects on these effective decentralized arrangements, and we would rather favour other dynamic and market based arrangements to attach value to secure supplies.

Yours sincerely,

Antonio Ciavolella
Regulatory Specialist