

Mr. Peter Sherry
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Ofgem
9 Millbank
London
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22 February 2011

Dear Peter,

RE: Gas Security of Supply Significant Code review (SCR) Initial Consultation

Centrica welcomes the opportunity to respond to this consultation on Ofgem's thinking on GB security of supply, which is being conducted under the guise of a Significant Code Review (SCR). This response is provided on behalf of the Centrica Group, excluding Centrica Storage Limited. The response is not confidential and may be placed in the Ofgem library.

To aid reading of this response, we capture the main points we wish to make in this letter, with more detail being provided on these, and on the responses to Ofgem's questions, in the attached appendix.

Executive Summary

Significant evidence exists that the GB gas market in its current form provides the right signals to adapt to changing supply patterns. More than £10bn has been spent to date in response to prevailing market signals in order to facilitate the massive evolution of infrastructure to support the transition from self-sufficiency to significant net imports in the light of declining indigenous supplies. This response has helped to ensure that we have never had a Gas Deficit emergency (GDE). Centrica's recent first-of-a-kind deal to secure long-term deliveries of 2.4mn tonnes of LNG per year demonstrates that the market arrangements continue to attract investment and gas supplies to Britain.

Poyry's work for DECC highlighted that market arrangements have delivered supply security. While it is right to establish whether incremental improvements, working with the grain of the market, could further improve supply security, we do not believe that any case has been made for wholesale, fundamental change to current emergency arrangements either ahead of, or during, an emergency.

Scope may exist for some targeted reform which focuses particularly on preventing an emergency occurring. For supplies into the network, this might extend to sharpening existing market arrangements, particularly incentives under cash-out arrangements, and keeping the market open as long as possible. We also believe that the demand side must play a significantly enhanced role in

delivering the adequate and timely interruption which is vital to protecting the overall integrity of the gas network.

However, we are deeply sceptical about Ofgem's ability to introduce a compensation mechanism, based on VOLL, that is sensible and does not distort the market. The workshop discussions highlighted the immense complexity such a proposal could involve and the scope for unintended consequences. The introduction of a compensation regime could lead to unlimited liabilities on suppliers even where they are clearly not at fault. Far from protecting customers, this could increase costs, distort commercial behaviour and erect barriers to market entry (even if an emergency never actually materialises). We do not believe a new regime for VOLL is appropriate for NDM customers in any circumstances.

Overall, we believe Ofgem must be more careful to specify precisely what problems it is trying to fix before leaping towards solutions. Market arrangements are not perfect and can be improved. However, we cannot afford important rule changes to be influenced by the overstated concerns set out in Project Discovery that suggested that greater reliance on imports necessarily requires a more interventionist approach to regulation.

Please don't hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,

Chris Wright
Commercial Manager

Appendix

Introduction and summary

Overall we welcome this opportunity for a thorough review of GB gas supply security. Many industry players, ourselves included, have on numerous occasions expressed concern at the way the current arrangements regarding supply security – including both those which apply in an emergency and those which apply on a “normal” day but which may influence the onset of an emergency – have developed. We agree with Ofgem that discussions to date have tended to be narrowly focused and piecemeal, and may not have included the requisite range of industry stakeholders to ensure that all aspects are fully considered.

We do, however, have concerns with this process. The industry does not have a clear, well articulated view about how secure gas supplies currently are (although evidence suggests supplies are very secure), or how secure customers want them to be (given that absolute security is impossible to achieve). Rather, this process seeks to define the tools with which to deliver an as yet undefined improvement in supply security.

We note Ofgem’s views that it has heard no compelling evidence to suggest it is wrong to pursue supply security improvements. Conversely, other than certain evidence of varying credibility (discussed further below), we believe that there is little firm evidence to suggest that change, and especially significant change, *is* required. By any measure, due process must prevail and that means making the case *for* changing economically efficient and well functioning market arrangements, rather than expecting respondents to make the case *against* a presumption that change is required.

This review would appear to us to have its origins in a number of issues, primarily the Poyry gas security report completed for DECC, and Project Discovery. We are also mindful that concerns may also have been raised by the winter of 2005-06, the Russia/Ukraine dispute, and the high demand levels seen over winter 2019-10 and early stages of winter 2010-11.

We have reviewed the detail of the Poyry report for DECC, which highlights scenarios in which the GB market may not receive adequate supplies. We agree that such scenarios are possible, but believe that these represent the boundaries of all plausible events that can reasonably be planned for - and therefore, events which shippers and transporters can reasonably be expected to take action to avoid.

Conversely, in our view Project Discovery highlighted irrational scenarios. We believe that, almost irrespective of the size of the incentives and/or penalties it would simply not be reasonable to expect shippers, suppliers and transporters to take actions which might have the effect of avoiding these most extreme cases. Indeed, given the extent of the investment needed to avoid these most extreme cases (which is likely to include, for example, developing “stand-by” network entry points and storage facilities which would deliver economic value only once every (say) 50 years), neither do we believe it would be in customers’ best interests to pursue such measures.

In respect of the other events listed above which may have given rise to supply security concerns, we would point out that on all occasions prevailing market arrangements have worked, and GB received adequate supplies throughout. Indeed, it is prevailing arrangements which have incentivised Centrica to secure the recently announced £2bn deal for the delivery of 2.4mn tonnes of LNG per year for the next three years.

Therefore, whilst we accept that it is entirely correct that Ofgem should consider *reasonable* future events and requirements, no robust evidence has been provided in support of extensive reform. That said, we do agree that there may be a case for incremental evolution of existing arrangements in order to sharpen certain market signals. Our thoughts on this are set out later in this response.

Further, while we welcome the efforts that Ofgem has put into consulting with the industry to date, we are concerned that the process followed thus far may not be seen by everyone as an exemplar of inclusiveness or thoroughness. On the first point, there is a risk that the exclusive nature of the workshops may have disenfranchised some who were prevented from attending. On the second point, while we recognise that Ofgem particularly invites consultation responses which provide alternative ideas, we believe Ofgem must also facilitate a process for open and active development of ideas and concepts other than its own. We now understand that Ofgem is considering at least one further workshop along these lines, and we welcome this.

Such a workshop may help to resolve an issue which has been widely discussed, that is; the differences between the “global commodity shortage” type emergency and the “multiple infrastructure failure” type of emergency. In our view there are different types of emergency, however we do not believe it would be helpful to have arrangements specific to each type – this might only lead to complexity, with confusion and arguments over which type of emergency prevailed, and therefore which arrangements should be followed. Rather, we believe that arrangements both before and during emergency must be flexible enough and provide the right incentives whatever the cause.

We also note that the subject of gas quality is conspicuous by its absence. This is a real issue which has come very close to constraining winter supplies through IUK during the last 12 months, yet is one which seems to have been swept aside. We have heard Ofgem state that, in its view, gas security is too important to be left to the market, yet this is precisely Ofgem’s approach to a Bacton treatment facility; arguably the most known about and likely constraint which exists at this time. We find this approach puzzling.

Responses to consultation questions

Chapter 3: Options for reform of the emergency arrangements

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?

The consultation does not adequately captures all options for reform; indeed far from it. While the document sets out at a high level the key areas where reform may be possible, it then goes on to set out some solutions with a presumption that those encapsulate all possible solutions. This is certainly not the case.

For example, we believe that there are a number of changes which could be made to the way in which shippers and NGG contract for, and exercise, demand interruption rights which are essential to preventing an emergency, but these are not discussed.

A further example where we believe reform could usefully be made, with comparative simplicity, is information provision. This could include information provided to NGG by shippers (for example steps being taken when the demand is (or is expected to) exceed supply), and by NGG to shippers (e.g. an increased number of pre-emergency stages, each of which might trigger a defined response).

We consider that further industry engagement is essential to ensure that only the most economic, efficient, and relevant reforms are fully developed and implemented, and welcome Ofgem’s proposed further workshop(s) as essential to achieving this.

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

We believe all three presented options are flawed for different reasons and would not support any of them.

Option 1

While we are not involved in developing or approving NGG's Safety Case, we would be extremely surprised if the HSE (the body responsible for approving this) would approve the lifting of the NEC's powers to maximise all indigenous gas production. We also consider this would be a serious retrograde step and on this basis we could not support Option 1 (indeed on this basis we do not consider it to be a genuine option for consideration).

Option 2

We do not accept that suspending shipper to shipper trading is either necessary or appropriate. We consider it far more beneficial to allow shippers to continue to trade with each as long as possible during, or possibly even throughout, an emergency. This is an activity with which shippers are familiar (familiarity with processes is always a benefit in an emergency) and will provide a valuable option for incentivising and resolving shipper energy balances. If it was considered undesirable for *all* shipper trades to feed into cash-out prices, mechanisms could be explored for removing the most extreme from the marginal price-setting role.

We do not agree that there is merit in NGG adopting the role of buyer of last resort from non-domestic sources. This is an activity which many shippers undertake on a daily basis, and therefore have established in-house skills along with the networks of deep inter-company contacts which are necessary to facilitate successful gas purchases. We do not see how NGG could possibly succeed at this role if shippers were unable to (other than possibly through an "open cheque-book" approach, if supported by HMT, and even then their lack of contacts would be a serious hindrance).

Option 3

As set out above, we tend to support maintaining market mechanisms as late into an emergency as possible, with some or all trades feeding into cash-out prices. There may still be a role for a post emergency claims process if the market were to be closed at some point. Also as set out for option 2, we could not support a role for NGG as buyer of last resort.

In addition, for all of these options, while we believe daily metered customers have an essential role to play in safeguarding the network through rapid and confirmable interruption, we do not accept that an administered VoLL is the best way of addressing this requirement. Arrangements currently exist whereby NGG undertakes an open tender process to procure ahead for demand side interruption to satisfy its Operating Margins requirements. This process provides for price discovery and therefore for VoLL to be set by a market. We consider that a similar process would be far superior than trying to administer a single VoLL for wide groups of consumers, and would result in significantly greater consumer "buy-in" to the interruption process.

We do not believe it is appropriate or desirable to require compensation payments to all domestic consumers. Such a move could potentially create unlimited liabilities upon suppliers and rapidly lead to business insolvency. Given the effects of socialised costs in the event of insolvency, the failure of a single large shipper/supplier could result in a domino effect leading to the complete loss of the gas supply industry. The interruption of firm supplies to a large number of domestic customers through commodity shortages would, in itself, probably be considered a national emergency, and therefore a situation where all possible efforts should be focused upon recovery from the event. We fail to see how arrangements which could quite probably lead to bankruptcy of the gas supply industry could possibly be seen as anything other than a severe distraction in such circumstances.

Given these issues, we are not even in a position to identify, from the three options presented, our "least worst" option.

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

We believe that in an emergency NGG must:

- Operation the gas system under the guidance of the NEC;
- Taking part in the NEC;
- Set system marginal prices through (at least some of) its balancing actions;

We do not believe it appropriate for NGG (or the NEC) to become buyer of last resort from non-domestic sources.

We are open-minded about the point during an emergency at which these roles commence and cease.

In addition, we believe that NGG must have a significantly expanded role *ahead* of an emergency. In particular, this must encompass demand side interruption, and greater information receipt and provision.

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

Ofgem's suggested pros and cons are a reasonable statement of the types of effects which the three listed options may elicit. However we don't agree that the options set out comprehensively captures all of all of the options available for reform of the gas market, and neither do they attempt to quantify the extent to which any of the listed pros and cons may bite. In short, we would be concerned if market reform decisions were to be based upon Ofgem's options 1-3, and the pros and cons set against them.

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

Removing the ability of the NEC to instruct indigenous production to maximum would, in our view, be a significant retrograde step. Indeed, were this power not to exist at present, it would rank alongside demand-side response as the most important safety step to be introduced as part of this reform. Therefore, not only could we not support this, but we would be extremely surprised if the HSE were to allow its removal.

We also wonder whether NGG might prove to be sufficiently inept as a gas purchaser of last resort, compared to leaving gas purchasing in the hands of shippers, as to constitute an additional safety case matter.

Further, where domestic compensation arrangements were such that suppliers faced insolvency, the ensuing confusion about who supplied which customers, and was therefore responsible for them, may also constitute a serious safety consideration.

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

While we believe Modification Proposal 0260 brought about an enhancement to the emergency regime by allowing shippers to potentially realise a near market value for excess gas delivered, residual uncertainty remains that claims may be rejected. This could serve to deter discretionary deliveries to the system under emergency arrangements.

Extending the period during which the market is open, with accompanying dynamic cash-out prices, deeper into, or even throughout, an emergency would remove that uncertainty. We consider that this

would provide the certainty that shippers and producers would need to make more positive decisions to deliver discretionary gas to the GB market.

Such a move would also speed up the payment process; a further disincentive implicit in the mod 260 arrangements.

Chapter 4: The potential case for enhanced obligations

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?

We are unable to fully respond to this question. In part this is due to there being no clear definition of “optimal” security of supply (and, therefore, no benchmark for assessing an outcome which may be “sub-optimal”).

Notwithstanding this, the GB market has proved extremely adept at responding to price signals - and even perceived opportunities ahead of price signals as evidenced by the recent extensive investment in import capacity. Nothing has fundamentally changed to alter our view that market signals remain the most economic and efficient way of delivering innovation and, ultimately, results, to the benefit of consumers.

However, we believe there are scenarios, for example, multiple loss of import/processing infrastructure, which shippers are realistically powerless to plan for and take action to “insure” against, no matter how sharp the price signals. We would include in this category building duplicates of all import, processing and storage facilities which could prove necessary to supply security, were the originals to become unavailable. In such cases, we believe that market players would, as now, continue to consider such events as force majeure.

That being the case, if it were deemed necessary to develop and build duplicate essential facilities, we believe that a “central planning” type obligation should be placed upon National Grid with associated costs being socialised.

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

Likely barriers would include major multiple infrastructure failings, and a global shortage of gas as a commodity. On this latter point, it could be that other markets would always pay more, thereby succeeding in attracting available gas, or that all gas production is forward contracted and therefore not available on the spot market, irrespective of price.

Overcoming multiple infrastructure failings would require significant diversification of supplies, almost certainly involving the development and construction of duplicate import and processing facilities. Even this, of course, could not guarantee supplies in all circumstances since such facilities would, themselves, be vulnerable to attack, mechanical failing, and global commodity shortages.

While it may be that massively enhanced GB storage capability could lengthen the onset of an emergency in the event of a global commodity shortage, in the most severe circumstances even this, of course, would eventually deplete.

In the end, we believe this matter comes down to (a) how secure society want its gas supplies to be (and this point has not been addressed), and (b) how much is it prepared to pay for it (again, not addressed).

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

We believe it is premature to consider obligations. In our view an adequate shortlist of market based reform options has not been established yet, and no consideration has been given to the ability or willingness of parties to respond to such market based incentives, or their ultimate effectiveness.

We remain entirely confident that, given a thorough development process, market based reform will adequately fill any reasonable gaps which may be perceived to exist in current supply security arrangements.

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

If a decision was taken that enhanced obligations were necessary, depending upon their nature these would probably best sit with National Grid, both from a planning and a cost socialisation viewpoint.

Question 5: How could obligations be designed and enforced?

As above, we believe it is premature to be debating the nature and enforcement routes for obligations, prior to ascertaining whether or not there is a role for obligations, which in any event should only ever apply where there is firm evidence of market based incentives failing.

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?

The range of potential obligations is extensive, and we would not wish to speculate about the pros and cons of each of each obligation which might potentially apply.

Chapter 5: Criteria for assessing options and next steps

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

We do not believe that we are even close to the stage at which a worthwhile impact assessment could be conducted. As already set out, we believe at least one of Ofgem's options is effectively invalid, due to the changes we believe would be necessary to NGG's safety case (and which are unlikely, in our view, to be approved by the HSE). The remaining two options only deal with matters of reform suggested by Ofgem, with no scope having been provided to date for open and inclusive debate around alternative reform models.

We consider that insufficient attention has been paid to developing a workable model for daily metered demand side interruption – this being probably the most important stage available for averting the onset of an emergency. It has become clear to us that this aspect of reform, if properly designed and implemented with market based VoLLs, could have support from a wide cross section of stakeholders. Yet discussions to date have tended to focus upon administered VoLLs, which encompass an extremely wide range, (and which workshop discussions have not refined by any appreciable measure), and are unlikely to be correct for more than a tiny minority of consumers.

In addition, we believe that there are a number of other options for market based reform which could well offer significant benefits over and above those proposed by Ofgem, but which have not been given adequate scope for development. To this extent, we consider that there has been foreclosure to ideas not propagated by Ofgem, and consider that this is likely to lead to sub-optimal outcomes.

Were Ofgem to conclude that market reform is required, market participants will have to consider what investment options exist to “insure” themselves against financial penalties/compensation liabilities. However, those same players will have a range of investment opportunities or requirements to consider, and will face the normal business challenges about securing the best return. Therefore, investment to avoid customer compensation under a “failure to supply” scenario, for example, is likely to compete directly with investment for delivering low carbon power generation. We do not believe that the trade-offs between competing investment requirements has been examined in anything like sufficient detail.

Any impact assessment carried out at this stage, therefore, will only consider a very limited range of ideas and impacts with significant reform options being excluded. With an issue of this magnitude, we do not believe this is appropriate.

Technical Annex – the value of lost load (VOLL)

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?

Shippers/suppliers are likely to shape their behaviour according to the level of any VoLL, and their exposure to it. If the purpose of this exercise is to create financial incentives on parties to enhance gas supply security, it must be extremely clear what the incentives and penalties are. Having incentives and penalties which are volatile (e.g. administered VoLL prices reset on seasonal basis), will cause confusion and apathy, and provoke sub-optimal responses.

Added to this, the response of many shippers will be to assess the options available to them for avoiding penalties; this could include establishing investment cases e.g. for the development of gas new storage. Any investment of this nature is significant and requires a high degree of certainty around costs (included avoided costs) and benefit. Attempting to seek Board level approval in the face of volatile prices which are established through a regulatory process is likely to be challenging.

We are also concerned at the effects of multiple VoLLs on the competitive market. For example, if a shipper were to invest based upon an aggregate VoLL of a particular customer portfolio profile, any deviation from this might change the return on the investment. This may deter shippers/suppliers from seeking to change their market position in an attempt to “lock-in” the investment return.

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?

We are unable to offer any solutions to this specific question other than the view that where possible VoLLs should be established through market mechanisms. This should be relatively straightforward for Daily Metered customers.

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?

For domestic consumers, VoLL will fluctuate significantly according to temperature (not just season), and this could be on a daily basis. It will also vary significantly between individual meter points – for example households with elderly or unwell occupants are likely to place different value on their supplies than households not in this position. We also believe that VoLL will vary according to household disposable income – with wealthier households prepared to pay significantly more for secure supplies than less well off homes.

Similarly, VoLL will vary massively between individual non-domestic consumers, although the seasonal element may have less of an influence on VoLL, depending upon the nature of the business.

If Ofgem intends compensation to be proxy for liquidated damages (i.e. the cost to a customer of being without a supply) , there is no reason why it should vary according to the duration of the disconnection (other than for the reasons given above e.g. temperature). However, reducing/removing VoLL by disconnection duration could serve as a useful limitation on suppliers' exposure to compensation.

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

Estimated VoLLs are likely to be much quicker and simpler to establish, but are also likely to be wrong for the vast majority of customers.

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

Anything other than targeting compensation payments at those responsible (e.g. short shippers) will serve to blunt incentives to avoid the onset and severity of an emergency.

Conversely, given the potential levels of compensation at stake¹, it is not unreasonable to assume that with or without socialisation of compensation liabilities, a GDE of any severity could quickly drive a number of suppliers into insolvency, with the resulting liability smear causing a domino effect.

¹ Example of compensation: Assume 5 million domestic consumers isolated from the network for 6 weeks at 3 therms per day and £25/therm. Compensation due would be £375m/d x 42 days = £15.75bn. These are conservative figures.