Gas emergency arrangements—taking the medicine

Ofgem's initial consultation on proposals for changes to the gas emergency arrangements as part of the Significant Code Review (SCR) process closed on 22 February. The regulator has identified this area as being in need of urgent and holistic treatment. As the first SCR to be launched under the regulator's new powers, this initiative on gas emergency arrangements will be watched with particular interest to see how effective the process is at facilitating major and complex changes to industry rules. In this week's *Energy perspective* we review the process to date and outline considerations that we think should be taken into account in developing remedies.

The bends

The drivers for this SCR arose from Ofgem's work on Project Discovery and the new EU gas security of supply regulation, which places new requirements on the authorities to put in place plans in the event of a gas emergency. As the country becomes increasingly reliant on imported gas, there are growing concerns on what might happen if supplies become tight, particularly when competing with countries that may manage security of supply differently.

Ofgem's specific concerns have centred round the fact that, in reaching Stage 2 gas deficit emergency, the cash-out price is frozen. This situation means that consumers cannot signal their willingness to pay more for gas, potentially encouraging further imports. In addition customers are not able to signal the value they place on security because there are currently no compensation payments for firm customer disconnections. The regulator also wants to review the roles of National Grid as system operator and as the National Emergency Co-ordinator.

Ofgem cannot be accused of dragging its feet. Following the announcement of the SCR on 11 January, it immediately issued a consultation. This was followed quickly by an opening seminar, three workshops during late January and early February and a closing seminar for the first stage of the process on 9 February. This joined-up review under the SCR is clearly necessary, particularly given fitful efforts in the past at amending the UNC. But although the process to date has given the issues a thorough airing based around three grouped options, it has not as yet produced a clear direction forwards. Indeed at the closing seminar the message from Ofgem was that there was no clear support for any of the packaged options, and they should all remain "on the table" for the impact assessment phase.

Bitterest pill

Any new gas emergency arrangements need to be thoroughly tested with regard to how they might affect different types of market participant. Ofgem in its impact assessment needs to consider not just the impact on existing competition, but also the barriers to entry, including credit requirements. For instance, the option of dynamic cash-out could have major credit implications for shippers, particularly smaller participants, reflecting the uncapped prices which may occur in an emergency period. Ofgem also expects this will encourage the industry to take out greater "insurance", which could reduce the likelihood of an emergency occurring. This sounds right in theory but in practice will be felt more acutely by smaller suppliers, as well as imposing additional costs on consumers. So even if the price becomes uncapped, this should not preclude some socialisation of the costs. Thought should also be given to an obligation to share gas still in the system, including in storage.

The options which suspend shipper-to-shipper trades may have attractions, particularly for smaller shippers, in that National Grid will take on the role of purchasing non-domestic gas. In the tight timescales likely to be available in the event of a gas emergency, a centrally-managed response should lead to a less disorderly market, but this could fundamentally change the risks faced by National Grid and the incentives on it will need to be carefully fashioned. Under two of the options National Grid is to be allowed to buy gas up to an administered Value of Lost Load (VoLL) (possibly more than one value) and for disconnected firm customers to be compensated at that level. It is far from clear how that value should be calculated and applied to widely differentiated customer classes, but the opting for an average has to be right. The arrangements for paying compensation, and the degree of targeting the associated costs on shippers, are further key issues to be resolved. But we think these costs can be best likened to collective insurance and the costs should be socialised.

Overall it seems that smaller shippers and suppliers may feel the brunt of the new arrangements. Any opening up of trading during an emergency, especially with dynamic cash-out pricing and uncapped liabilities, will favour better resourced players that can assimilate the increased complexity and afford excessive credit. Conversely customers of smaller and niche players should not be disadvantaged because of an insistence on market-based norms in circumstances that by definition are premised on a cessation of normal market rules.

Electric shock

One key issue Ofgem needs to get to grips with is ensuring that any arrangements put in place for gas can co-ordinate with the arrangements for dealing with electricity emergencies. This criteria is listed as a possible "risk and unintended consequence", but it takes on particular significance given the growing importance of gas to the power system.

The emergency arrangements in electricity are far from perfect despite their development over nearly a decade. These include the Fuel Security Code where the Government can direct generating plant to operate in a particular way following loss of generating capacity and/ or a loss or shortage of fuel. There are also contingency provisions in the BSC in such emergencies for a single imbalance price based around historic price limits, which are very different to the dynamic prices canvassed by Ofgem for gas. A further variable is the likely and necessary reintroduction of a capacity payment mechanism under the electricity market reform process, probably administered on a targeted basis.

A spoonful of sugar

On the basis that prevention is the best cure, one issue neglected to date is the role of the demand side in an emergency. The work done in 2005-06 on UNC086 (*Introduction of gas demand management reserve arrangements*) seems very pertinent here. The mod attempted to introduce a more structured approach to demand-side response in the gas sector by the system operator and overcome some of the barriers of the traditional commercial interruption products.

At the time Ofgem narrowly rejected the mod on the grounds of imprecise cost targeting (it wanted to load all the costs on the marginal cash-out price for short shippers, despite the proposed mechanism being intended more as an insurance measure).

The remedy

Ofgem will publish a draft decision document early Summer. This will be followed by further seminars and workshops. There are two potential routes that the subsequent consultation process could then take: Route 1—if the new statutory powers in the pending Energy Bill receive Royal Assent before Summer 2011, Ofgem could direct National Grid to make modifications to the UNC following the gas SCR consultation; or Route 2—if the statutory powers are not in place before Summer 2011 it will follow the SCR process, which would allow Ofgem to direct National Grid to raise a code modification proposal reflecting its conclusions. We can then expect reforms to be in place around Spring 2012.

There remains a long way to go. The present gas emergency arrangements may not be fit for purpose, but the impacts of the different options are only just beginning to be identified. Ofgem should be very wary of arguments that suggest the market would work in extreme circumstances, though unfreezing the cash-out price (or replacing it with a high administered price) seems unavoidable, although the adverse credit consequences need to be mitigated. But Ofgem needs to be particularly aware that the cure can be worse than the disease, especially if perverse incentives are created through interaction with electricity emergency rules.

The interests of consumers as a whole are much more likely to be protected by a managed response through National Grid as system operator, combining the role of the NEC. The costs of its actions, including new reserve and interruption actions, should be socialised as an industry insurance cost. These observations would seem to point us firmly down the path of option 2.