

Gas Security of Supply Significant Code Review

1. INTRODUCTION

EEF is the representative voice of manufacturing businesses with a membership of over 6,000 companies employing more than 800,000 people.

All EEF members are energy consumers, and for many access to secure and competitively priced gas is crucial to the future of their business. So we welcome the opportunity to provide a manufacturing perspective on Ofgem's review of gas security arrangements.

2. SCOPE OF THE REVIEW

EEF shares Ofgem's concern that current gas market arrangements will not deliver long-term security of supply. However, in our opinion, the scope of this review is too narrow to address the issue. It focuses exclusively on reforming the administrative arrangements for dealing with a "Gas Deficit Emergency" (GDE) – i.e. a national shortage of gas.

The current "emergency arrangements" are in need of reform, there is scope to better target the costs of resolving a national gas shortage and improve compensation for any consumers who are disconnected as result. So a review is welcome and timely.

However, the threat to the secure and competitively priced gas supply essential to many manufacturing industries goes beyond the prospect of a national shortage. Growing dependence on imported gas is exposing the UK to an increasing range of potential supply shocks.

These include the failure of import infrastructure (e.g. pipelines and LNG terminals) and reliance on overseas gas markets in which political considerations override economic ones (e.g. regulations that prioritise domestic consumers over exports in the event of a disruption). Such events can, and have already, led to localised disconnections of manufacturers and sustained price spikes causing significant damage to energy intensive industries.

The market needs to provide better insurance against the whole range of emerging issues threatening future UK gas supply. Reforming the emergency arrangements alone will do little to address them. We believe Ofgem should broaden its review to take into account the full range of threats and potential solutions.

3. OPTIONS FOR REFORM OF THE EMERGENCY ARRANGEMENTS

Within the narrow context of a review of the emergency arrangements, the range of potential reforms considered in the consultation document is appropriate. All focus on tacking the key issues of better targeting the costs of dealing with an emergency and ensuring any consumers disconnected as a result are adequately compensated.

However, it is imperative that any reform of the emergency arrangements avoids creating further barriers to entry in an already highly consolidated gas supply market. For example, the prospect of significantly higher penalties for being short of gas during an emergency could increase the credit requirements for operating a supply business.

4. LIMITATIONS OF RELYING ON PRICE SIGNALS ALONE TO DELIVER SECURITY

The rationale for the review appears to be that the prospect of tougher penalties for suppliers short of gas during an emergency will prompt utilities to take more effective preventative actions beforehand.

EEF is not convinced that sharpening price signals during an emergency will have a material effect on long-term security of supply. Whilst it could reduce the severity and duration of an emergency, which is important, it is highly debatable that it would reduce the likelihood of one occurring in the first place.

Fortunately, to date, there has never been a national gas shortage in the UK. However, the UK natural gas industry is barely 50 years old and were one to occur the economic and social impact could be very significant.

There is considerable evidence to suggest that the risk of high-impact but low-probability events, such as a national gas shortage, is difficult to manage effectively through price signals alone. Not only do individual market participants lack responsibility for overall security of supply, the likelihood and consequences of a gas shortage are very difficult to predict.

In the context of gas security, it is not obvious why utilities would alter their investment and risk management strategies on the basis of the potential consequences of an event which has never occurred, is unlikely to occur and if it did would likely trigger prompt government intervention to mitigate the effects on the economy.

More pertinently, no evidence is provided in the consultation document that the current emergency arrangements are actively discouraging utilities from taking out adequate insurance measures against the risk of future disruption to gas supplies - e.g. investment in gas storage, interconnection with overseas markets or demand-side response.

In addition, reliance on price signals alone to deliver security of supply ignores the diversity of gas market arrangements in Europe. The UK is increasingly connected to and reliant on supplies from a range of European markets that operate under very different rules. For example regulations that prioritise domestic consumers in the event of disruption and encourage long-term gas contracting prevalent in many markets, mean continental European gas flows will not necessarily respond to UK price signals during a shortage.

5. REVIEW NEEDS TO REGULATORY SOLUTIONS

A more proven way of safeguarding security of supply for consumers would be an obligation on suppliers to meet their customers' needs in the event of a disruption to supply. Such obligations are common place in continental European gas markets and could be discharged through a variety of means from investment in storage to procurement of demand-side response and entry into long-term supply contracts with producers such as Centrica's recent deal with Qatar.

Crucially, from an industrial investment perspective, clear and regularly audited obligations would provide greater confidence in the security of UK gas supplies.

In our opinion an obligation would best be placed on suppliers rather than the System Operator. Suppliers have full commercial freedom to take up whatever insurance policy and risk management strategies they see as most efficient and cost-effective.

We note Ofgem's concern that there are "complex design issues" with obligations and that they should not be considered "an easy option". Whilst designing an obligation would not be a trivial exercise, there is more experience and precedent to draw on when designing an obligation than a market reliant on price signals alone to deliver security of supply.

6. ASSESSMENT CRITERIA

The assessment criteria for the policy options developed during the review should be expanded to include economic competitiveness. Energy supply is not an end in itself, but a means to deliver products and services valued by consumers such heating, lighting and manufactured goods.

For manufacturers, especially energy-intensive ones, a secure energy supply is vital to their international competitiveness and ability to attract investment. The cost-benefit analysis for this review should consider the impact of different packages of reforms on industrial competitiveness.

7. DIFFICULTIES ESTIMATING THE 'VALUE OF LOST LOAD'

An accurate measure of the value consumers place on a secure gas supply – i.e. the so-called Value of Lost Load (VoLL) – is an essential element of all the options identified for reforming the emergency arrangements. However, EEF is highly sceptical that a single or manageable number of accurate measures of VoLL can be established.

In manufacturing alone, establishing an accurate measure of VoLL would be a daunting task. The value a company places on firm supply varies considerably and depends on a wide range of factors such as energy-intensity, the role of gas in the industrial process and whether or not that process is one which requires continuous and uninterrupted operation.

Furthermore, there are less tangible but very important dimensions of VoLL which are even harder to capture. For example the reputational damage of the failure to deliver an important order due to a disruption in energy supply or the impact of international perceptions of UK energy security on inward investment in manufacturing.

The difficulty inherent in accurately measuring VoLL suggests to us that alternative approaches to safeguarding security of supply, such as licence obligations, should be given greater attention as part of this review.

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