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22 February 2011

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Initial Consultation - Gas Security of Supply SCR

By email to gb.markets@ofgem.gov.uk

We welcome the opportunity to provide comments on this consultation. ExxonMobil International Limited is responding to this consultation on behalf of its wholesale gas marketing affiliate and UK gas shipper ExxonMobil Gas Marketing Europe Limited.

Both the timing and scope of this SCR are justified and we support the review. It is appropriate to review Network Code Gas supply emergency arrangements in parallel with the Government's review of Electricity Market Reform. The UK energy sector is in a phase when its reliance on imported gas supply is increasing as the level of domestic (UKCS) supply is falling. Both Government and Ofgem have expressed concern in the recent past about whether expectations of security of energy supply (gas and power) can continue to be met in these circumstances. This review is the opportunity for the gas industry to consider changes that may be made to market arrangements both to help ensure clarity of price signals with the value of security of supply reasonably reflected in those signals.

We believe that the drivers for the review include (i) assessment of the adequacy of market based price incentives (shipper cashout prices) to avoid a gas supply deficit in the first instance and (ii) an assessment of suitable arrangements required to ensure gas supplies can be accessed for an efficient and sustained recovery from a gas supply deficit. Whilst not directly relevant to our wholesale market interests we accept that it makes sense for Ofgem to consider as part of the same review (a) the appropriate level of consumer compensation in the event of firm load disconnection and that (b) this may in turn guide a maximum price for cashing out imbalances.

Reviews of gas emergency arrangements involve a wide number of interested parties (Government, Health and Safety Executive, small and large retail and wholesale suppliers, the TSO and the Network Emergency Co-ordinator); the number of terms of the UNC that may need to be considered are similarly extensive and the review is in a relatively complex area. Consequently, sufficient time must be given for a thorough and complete analysis and

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whilst we understand that there may be some interest from Government to implement changes before the next winter, we would expect Ofgem to resist that if it saw that more time was needed. The challenge for Ofgem/industry is to find those changes (perhaps a limited number of small refinements rather than a significant restructure) that "*work with the grain of current market arrangements*", an objective expressed by many workshop participants and one with which we fully agree.

The initial workshops were an important first step for Ofgem to take to help ensure engagement of all sectors of the industry. We would encourage Ofgem to maintain and broaden this level of engagement where it reasonably can to help ensure the most robust, supported final outcome.

The workshops have raised a variety of issues raised that need further consideration and we would like to note here a few of the issues that we believe require a particular focus :

(i) Addressing the question as to whether or not an administrative price cap on cashout should be hardwired into the UNC.

(ii) Finding an effective/efficient solution to unlock indigenous demand side response capability as one of the important potential routes to delay or avoid the onset of a Gas Supply Deficit. One aspect that would be important to cover in this exercise is the extent to which gas CCGT could or could not be interrupted based on power security of supply.

(iii) Reviewing the principle that compensation costs should be targeted at those who are gas short in the context of the strong credit arrangements that would be required to support that. Analysis of the credit risks and the possible implications of requiring more robust credit arrangements is an essential part of this review.

(iv) Further examining the case for retaining the current post emergency claim process that allows the opportunity costs to be recovered for gas supplied into the UK above the level required by a shipper to balance (and even were dynamic cashout pricing to be implemented).

In the Annex attached to this letter we include some further views on questions raised in Ofgem's initial consultation. Please do not hesitate to contact us should you require any clarification.

Yours sincerely

Ian Trickle

Annex

Comments on Consultation Questions

CHAPTER 3

Q1: Have we captured the appropriate range of options for reform of the gas emergency arrangements? Are there other options that should be considered ?

Broadly, yes.

At the workshops it was suggested that the NGG Top Up arrangements of a few years ago might be a further option and although there were counter arguments that these would unlikely deliver any benefit (and may produce unintended consequences), we think it would be worthwhile spending more time exploring such schemes.

Ofgem and others have recognised that a gas supply emergency may arise either very quickly with very little time for the market to react or may be of a "slow burn" type where the market has time to signal an approaching period of supply stress. The combinations of rules to deal with either of these alternatives may be different and the industry should consider what those differences might be.

Q2: Of the three options presented, which do you prefer? Why?

Subject to a full review of the consequences, at this stage we would prefer Option 1 as this is a straightforward extension of current proven market arrangements that already operate up until Stage 2 of an emergency.

However within the changes encompassed by that option we have expressed concerns about the risk of supply withholding that might be incentivised if the Code were to include an explicit VoLL cashout price cap hardwired into the terms.

The Network Emergency Co-ordinator will under this Option lose the ability to authorise NGG to order maximum UKCS supplies; we think this will be of increasingly small consequence as most if not all UKCS fields are being continuously produced at maximum possible levels. Ofgem should seek expert advice on the extent to which this loss of control by the NEC to authorise maximum production would or would not alter the course of events at the early stages of Gas Supply Deficit.

Q3: What is the appropriate role for NGG in an emergency?

National Grid's buy-sell actions on the OCM are the basis on which cashout marginal prices are set. NGG already has a range of tools it can use to reconfigure system flows where that is required and those tools additionally allow it to minimise the cost of balancing the system at the configuration required.

In any actual emergency, parts of the distribution network may be depressurised constraining flow options on the transmission network. The question is whether NGG's system *management tools would be adequate to manage the network in emergency conditions as in normal operating conditions.*

As long as the suite of system management tools is considered sufficient, NGG's role may remain unchanged during an emergency. Whether it should have an enhanced role or additional management tools is already a topic for industry discussion.

Q4: Do you have any comments on our initial assessment of the pros and cons associated with each option?

Broadly we agree with Ofgem's analysis.

Q5: Are there any safety case implications associated with each option?

The Safety Case must continue to evidence that safety of operations can be maintained for any changes made to Section Q terms including those where dynamic cashout and normal shipper to shipper trading on the OCM is maintained.

If NGG believes that it can control flows on the transmission network using its various system management tools, to match safe operations flow and pressure requirements then at first sight it would seem to us that would be sufficient to demonstrate the Safety Case. However this is an area for expert review.

Conversely if NGG can demonstrate any circumstances where it may not be able to control flows safely (including flows that may be set by the DNO's) then it should identify these and industry should consider the additional tools NGG may require.

Q6: What benefits would dynamic cash-out bring relative to the post emergency claims arrangements?

As an ex ante arrangement dynamic cash out directionally increases the opportunity to continue avoiding a Gas Supply Deficit in periods of supply stress. The ex post arrangement of post emergency claims is not as transparent as an upfront price signal. In any event Ofgem/industry should consider all possible reasons or occasions where the post emergency claims arrangement might usefully be retained.

CHAPTER 4

Q1: 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?

Confidence in the effective functioning of the UK wholesale market is as important as the transparency and clarity of the price signal/incentive. As long as these two components remain in place we can foresee no reason why the UK should not obtain gas supplies at a level consistent with the strength of the price signal.

Of course it is always possible to envisage events, however unlikely, that might prevent UK demand from being fully met – supplies scheduled for ship or pipeline delivery could be disrupted by acts of god or terrorism. Where the price signal is strong the level of competition in supply directionally increases and an unplanned event affecting delivery of one competing supply simply provides the alternative options with less price competition.

The risk of a single such major event is already low but the risk of multiple overlapping supply events is very low or de minimis; insurance schemes, including supplier or TSO obligations, designed to cover such multiple overlapping supply events would likely be prohibitively expensive.

Q2: What are the likely barriers to attracting gas imports during a GDE? Could these barriers be overcome?

Ofgem's own analysis covered in paragraphs 4.12 through 4.16 considers potential barriers including the existence of differential security standards across continental Europe. Some Member States operate PSO's and strategic provisions and as long as these provisions continue to exist the UK price signal may be less effective in attracting a fully diverse range of supplies. However we are convinced that there is nothing to be gained by the UK adopting or competing with such arrangements as this introduces a race for the toughest security standards with all the impacts that will have on consumer prices. Instead the UK should adopt a position within Europe that seeks the progressive removal of PSO's and strategic provisions as market arrangements develop in line with Third Package requirements.

As far as LNG is concerned there are response time considerations to ordering new supplies. Response time simply depends on the geographical distances that may need to be covered. With the number of LNG ships serving the Atlantic market steadily increasing the probability of one or more cargoes being within a day or two sailing from the UK will also steadily increase.

In circumstances where a major gas supply is disrupted rapidly over a day or two, reliance on storage drawdown, pipeline supply and demand side response will generally be greater than reliance on LNG supply if curtailments are to be avoided. This emphasises the importance to be attached to preserving the effective functioning of the UK gas market as part of making progress towards a fully integrated Europe wide market so that (assuming removal of PSO's or strategic reserves) the UK has access to the full diversity of gas supplied into Europe.

Looking to the future there is a point to be made about the level of wind/gas intermittency present in UK power generation. As wind contribution to the power sector increases so does intermittency of the gas backup requirement – this places additional short term stress on gas supply response and gas price volatility could become a significant issue that may have negative consequences for supply to the UK. This is an area that Ofgem might want to explore further as it considers the input it provides to Government on Electricity Market Reform.

Q3: Do you think that the risks associated with sharpening price signals make it necessary to apply additional obligations on relevant parties?

No, we do not see any risk or circumstance today that would provide sufficient reason to apply additional obligations on relevant parties.

Q4: If enhanced obligations were applied, to whom should they be applied and why?

Assuming that for whatever reason a "choice" has to be made and assuming the choice is limited to the TSO, gas retail suppliers or gas wholesalers then our preference would be to limit additional obligations to the TSO as this would most likely ensure costs can be minimised.

The nature of any such additional obligations could be preventive or curative. Preventive obligations might include an obligation to establish and operate a system to identify and contract demand side response from consumers who can interrupt or partially interrupt offtake.

As has been pointed out in the workshops any obligation on the TSO to act as a central contracting party with external suppliers to the UK (as opposed to shippers who have those business relationships) would be the least welcome of any imaginable TSO interventions. The TSO is not qualified for commercial activity at this level and in any event can deploy System Management tools with gas shippers who hold those relationships.

Q6: 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 risks and potential consequences depend precisely on the nature of obligations under consideration but our general view is that obligations distort the operation of the market and limit efficient choices. The consequences are generally those of increased uncertainty, reduced confidence in the market and higher costs for consumers.

TECHNICAL ANNEX

Q1: 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?

We can see arguments for a standing regulatory power to be able to step in and cap cashout price (at a level dictated by all the circumstances at the time) where that was required to maintain an orderly market.

However we are concerned that a single, fully supported, hardwired, administrative value will be difficult to get agreement on; there is likely to be a very wide variance in VoLL according to (I) consumer class (ii) consumer specific use and availability of direct backup (iii) seasonal considerations (iv) subjective measures of "value".

Q5: What sort of compensation arrangements should be used to apportion the costs of compensation between shippers?

As Ofgem notes in paragraph 1.50 and 1.51 "there is moral hazard caused by the potential mismatch between the consumers interrupted and short suppliers. In particular, as customers are generally interrupted on the basis of maintaining a safe network, it is rare that the customers that are interrupted are also the customers of those suppliers that have caused the interruption. Hence, there is little reputational risk from being short. If compensation were to be introduced this could address the moral hazard issue but this would depend on how compensation was allocated to shippers/suppliers. The moral hazard is likely to be more of an issue where costs are not targeted at those responsible for them. In previous discussions of dynamic cash-out industry participants expressed concerns that targeting costs in an emergency would be inappropriate as shippers would be unable to react to incentives. This has been used as a justification for not pursuing a more dynamic form of cash-out. If this rationale were relevant here, it may be considered appropriate for the compensation costs to be spread across all shippers by throughput"

We support the targeting of costs to those that have caused them but this assumes that credit arrangements are sufficiently robust to support the operation of this principle.

Ofgem suggest that Day 1 short shippers should pay their imbalance costs into a compensation pot for subsequent redistribution to retail suppliers in proportion to the number of their consumers interrupted. Ofgem moves on to argue that a Day 1 short shipper might become liable not only for its share of first day compensation to disconnected consumers but for the full period of interruption involved. This has some merits but it is worth pointing out that shippers have little control over the restoration process and it may be appropriate for Ofgem to consult on and set standards for supply restoration and use these standards as a basis for capping a shippers liability.

In the "slow burn" emergency case there would seem to be an argument that short shippers imbalance costs might be placed into the compensation pot for a period leading up to the emergency as well. This allows for the possibility that a shipper or shippers continuous shorting over several days prior to Day 1 might actually have been the cause of a Gas Supply Deficit.