first:utility

GB Markets Team
Ofgem
9 Millbank
London
SW1P 3GE

February 22, 2011

Dear Sir,

Gas Security of Supply Significant Code Review Initial Consultation

Please find First Utility's response to your formal information request below.

Chapter Three

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 options presented by Ofgem seem comprehensive.

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

First Utility prefers Option 3 as this provides some measure of risk mitigation for smaller suppliers who might be exposed to extremely high cash out costs in an emergency. If Ofgem were to select Option 1 as its solution, the introduction of a dynamic cash out price in this situation could impose a cost upon smaller shippers which they may be unable to meet with the potential resultant impact on competition and consumer choice. In addition, the resultant impact of Option 1 on credit arrangements for shippers would also potentially be a serious issue for smaller players. We also agree with Ofgem that Option 3 has the potential to minimise the duration and severity of a Gas Deficit Emergency if this were ever to take place. However, we agree that the selection by Ofgem of Option 3 would need to be accompanied by enhanced security of supply obligations as the cash out structure proposed under that option might not necessarily incentivise gas delivery during a Gas Deficit Emergency in an appropriate manner.

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

As proposed in Option 3, we would support NGG being the sole purchaser of gas from non domestic sources in a Stage 2 (and beyond) emergency situation, with the costs of this being socialised across the industry.

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

We agree that, while Options 1 and 2 provide a stronger incentive for gas delivery during a Gas Deficit Emergency, the introduction of a dynamic cash out price might constitute a barrier to entry as the potential resultant cash out prices might constitute an unacceptable level of risk for smaller players. By contrast, while Option 3 addresses this issue it does not necessarily provide as strong an incentive for gas delivery. With regards to complexities in implementation, it seems likely that,

whichever of the three options Ofgem approves, changes to NGG's incentive arrangements will be required. We welcome the fact that all three of the options under consideration introduce compensation for firm customers disconnected based on administrative VoLL(s).

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

We are not aware of any.

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

Dynamic cash out would potentially provide a stronger incentive to balance and to deliver gas during a Gas Deficit Emergency. However, as already mentioned, we believe the risk and increased credit requirements that would result from this arrangement could potentially constitute a barrier to entry for smaller players.

Chapter Four

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?

There are a number of possible reasons for this, including price differentials between the UK and other markets leading to a reduction in available spot gas and the difficulty of assigning a correct VoLL for firm sites.

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

As above, we would suggest that potential price differentials between the UK and other markets in an emergency situation might make it more likely that spot gas is delivered elsewhere. Long term take or pay gas contracts in European markets may also have an effect on this.

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

This would seem appropriate as sharpening price signals could potentially create a stronger incentive for gaming as the potential risk and profit of the market moving in a certain direction during an emergency situation would be magnified.

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

We believe that, if enhanced obligations were applied, they should be placed on shippers as it is these parties who actually own the gas. We believe the obligation to make gas available should apply in a Stage 2 (or greater) emergency situation and should also require shippers to make available any gas held in storage.

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Question 5: How could obligations be designed and enforced?

Obligations should be designed in conjunction with an industry wide consultation process. We feel that any obligations agreed should then be included in Condition 5 of the Gas Shipper Licence.

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?

It is possible that some smaller shippers may be less able to meet obligations to make gas available than larger shippers. However, this will be largely dependent on the way the obligations are designed.

Chapter Five

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

We believe the range presented is comprehensive.

Technical Annex

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?

Different customer groups are likely to place a different value on the ability to continue to receive gas depending on the industry in which they are involved, differences in average consumption etc. Therefore it would seem appropriate to have multiple administrative VoLL settings for different 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?

We would suggest that a single administrative VoLL setting be applied at VoLLaverage. Although we recognise that this is not perfect, we believe greater unintended consequences could result from applying the setting at VoLLmax or VoLLmin than at VoLLaverage. In addition, we are uncertain as to the feasibility of other users entering into interruptible contracts for price discovery purposes as interest in these has to date, under the new arrangements introduced by UNC Modification 90, been quite low with GDN acceptance of offers made even lower.

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?

We believe that this should be the case as gas prices tend to be higher in the Winter than in the Summer, so VoLL would logically be higher in this period. In addition, the longer an interruption lasts, the greater the economic and intangible consequences of this which would also potentially affect VoLL, at least from the customer's viewpoint.

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

It is extremely difficult to assign an appropriate VoLL, particularly as different customers may have different criteria for assessing that value. We would consider revealed preference methods to be superior as they are based on actual actions. Stated preference methods can be more misleading but we accept that these have a use in filling in gaps where revealed preference data is not available.

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

We accept that the moral hazard issue causes concern both at Ofgem and in the wider market. However, if Ofgem elects for dynamic cash out prices in a Stage 2 or greater Gas Deficit Emergency, smaller suppliers may find themselves short through no fault of their own as a result of customer activity and then find themselves unable to cover this short at a viable price in a rapidly rising spot market. Targeting them with a proportion of the VoLL cost as well might potentially have the unintended consequence of pushing them into insolvency. Nevertheless, as we accept that the moral hazard issue is a very real one, we would support cost targeting of VoLL on short shippers for the first day of a Gas Deficit Emergency followed by socialisation of VoLL on subsequent days if Ofgem elects for frozen cash out prices. In the case that Ofgem elects for dynamic cash out prices in a Stage 2 or greater Gas Deficit Emergency we would request that VoLL costs be socialised for the reasons listed above.

Please do not hesitate to contact me should you require any further information.

Yours sincerely,

Chris Hill

Regulation