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Dear Peter,

Re: Ofgem's initial consultation on the Gas Security of Supply Significant Code Review

Thank you for the opportunity to respond to the above consultation.

Summary

The Forum believes that in an emergency the GB gas customers would benefit from arrangements that:

- Protect the safety of the system;
- Respond to different types of emergency;
- Have the ability to alter prices in light of global gas markets to encourage gas imports to come to the market;
- Encourage customers who are able, to interact with the market via interruption arrangements;
- Recognise that in a market with high prices, credit issues will inhibit trading; and
- Operate with proportional rules and obligations which do not create barriers to entry for new shippers and suppliers.

Introduction

The Gas Forum was established in 1994, acting as a body that represents the views of Gas Shippers and Suppliers active in the GB Market. The Forum now counts among its membership virtually every significant GB gas shipper and gas supplier. As a group, we work with Ofgem, other policy makers and opinion formers to develop the gas market in such a way as to deliver secure supplies, at competitive prices to GB energy customers.

The Forum welcomes Ofgem's review of gas emergency arrangements and believes that a holistic review provides an opportunity to examine whether the market feels that current arrangements remain fit for purpose. If incremental changes that could enhance security arrangements are required we believe that these can be progressed via the normal modification process. It is vital to the market that any changes are made in a transparent manner and provide clarity over how emergencies will be handled as they arise, as well as rules surrounding the necessary post emergency accounting process and the practicalities of the arrangements.

The Forum has previously expressed concerns with the transparency and speed of the formal consultation process undertaken to date. Our members are always willing to work with Ofgem to develop policy that meets regulatory requirements and provides pragmatic business solutions. Excluding any parties from policy development is unwelcome and we do not believe Ofgem would accept similar behaviour by the industry, for example excluding parties from UNC working groups. Experience suggests that few additional parties would have attended the sessions had they been open to all and this would have maintained the important principle of open and transparent policy development which is vital to reduce regulatory risk, whether real or simply perceived. To help improve the process, the Forum would be happy to invite all interested parties to attend an all day Forum workshop with Ofgem to discuss their proposals in more detail. We welcome Ofgem's offer to hold additional meetings of this type and are happy to facilitate broader consultation. We also welcome the frank discussions we have had with Ofgem and a move towards a more collaborative approach to policy development.

The process has also allowed very little time to bottom out the details of some of Ofgem's initial proposals. The Forum recognises that Ofgem has committed to further consultation, but we believe that more time could usefully be spent examining some of Ofgem's preferred policy changes, particularly comparing them to the baseline. The Forum hopes that Ofgem, if it does propose change to the current arrangements, clearly demonstrates why the proposals are better than the baseline. If in developing their model in more detail Ofgem would like to discuss ideas with the Forum we would be happy to arrange additional time to help Ofgem with their policy development.

As already raised with Ofgem, the Forum believes that emergency arrangements need to be flexible as emergencies can develop over differing timescales each requiring different responses. We believe what is important is that the arrangements should aim to: ensure safety; minimise loss of supplies as much as possible; protect businesses who have acted in a prudent manner from insolvency; and allow commercial consequences to be resolved quickly and efficiently after an emergency event.

Ofgem's Options

In general, the Forum believes in the case of a slowly developing emergency, for example a problem on the continent limiting supplies, that the current arrangements would appear to be robust, at least in principle. The key change over recent years has been our increasing reliance on imports. As prices may need to rise to attract additional imports, an incremental improvement to the way prices are set, possibly just to attract imported gas rather than across the market as a whole, may be sufficient to achieve the objectives stated previously. The required gas imports could be bought in to the UK on the basis of bi-laterally agreed prices either between the shippers and the importer or via the NEC buying gas. The Gas Forum recognises, however, further consideration is needed, for example, with regards to setting an appropriate price for a market, which is effectively broken, contractual constraints (which may exist in other markets), market liquidity, and so on.

At the present time, the Forum does not believe that Ofgem's proposals are worked up in sufficient detail for us to fully understand how they would operate. For example, we are unclear how dynamic prices might operate in option 2. We are concerned that arrangements could create signals that some parties may not be able or willing to respond to, and as a result could generate significant and disproportionate costs. We also have concerns about the practicalities of compensation for all customers and the potential creation of unlimited liabilities, impacts on supply competition, etc... However, as a principle we believe leaving the market to work, where possible, creates effective incentives for all market participants, including customers, to work with the SO to achieve effective and reliable market outcomes.

Generally the Forum are not sure that the case for change has been made in the processes to date. To ensure any changes are not open to challenge, Ofgem will need to demonstrate that change is needed and that the changes they propose will work better than the baseline, and be economic to implement and operate. The Forum recognise that this is difficult due to the nature of emergency planning, but we would welcome some robust analysis as to why current arrangements are not fit for purpose and why any proposed changes would better meet the objectives set out at the start of this response.

Key principles

VOLL – The Gas Forum believes that the shippers/suppliers do already have knowledge of larger customers' VOLL, we simply do not, as a market, refer to it in those terms. Amongst our members, many have contracts with customers that: allow customers to interrupt and “sell gas”; or clauses that allow the sharing of the value of gas where interruptions occur; or arrangements to buy gas at daily rates. In a slowly developing gas supply shortage, before a full emergency is reached, shippers would be contacting all of these customers to seek load management. Each customer's VOLL will be indicated when they are interrupted and they will be compensated based on the relevant commercial terms.

What the market does not know is the volume transporters would likely require in an emergency. It would be helpful if each transporter could estimate how many large customers, on each network, may need to “come off” under a range of scenarios; for example a reduction in supplies from the NTS of 10%, 20%, 30%, etc... This information would allow shippers/suppliers to consider if current contracted volumes are sufficient. The Forum members would welcome this type of information to allow us to ensure that we are able to carry out quantitative assessments based on actual information. We do recognise that in an emergency which develops quickly, these contracts may be of less value.

In terms of setting VOLL for the wider market, we are not convinced that this is practical, or helpful. The Forum believes that Ofgem is right to recognise that customers may be willing to pay higher prices for supplies on, say, cold days. However, the price levels will vary by customer type, time of year, etc... Under an emergency it may be better to make a decision about the price of gas on the day in light of the circumstances at the time. This would allow account to be taken not only of conditions in the GB market, but also in global markets against which the GB market now competes for some gas supplies.

Another concern the Forum has with an ex-ante set VOLL, is that customers will know this value and this may influence the market for interruption such as to push up interruption costs to shippers, and thus increase the overall cost of the gas supply chain. Ex-ante VOLL may make customers less willing to enter such contracts at prices lower than the defined VOLL in future and make it difficult to trigger commercial interruption in the run-up to an emergency. Also, if trading parties know the price can rise to a set level it may create an incentive for prices to go higher, faster.

The Forum is also concerned that the value of VOLL does not, in the early stages of an emergency, result in smaller customers getting cut off, so even if customers know in advance that interruption may start when the price hits a predetermined level, creating the signal does not necessarily incentivise the response the policy may be hoping for. In the future, with the rollout of smart metering more customer interaction may be worthy of further consideration. If contracts with “time of day pricing” develop we will be able to gather

information on the value of VOLL. At the current time we are not convinced that a centrally determined VOLL provides a useful tool in an emergency.

We are interested in Ofgem's idea that customers may need to be compensated for lost supplies. An administered regime where customers are requested to interrupt and are paid to do so, may incentivise a quicker response from customers. Smart metering, and Project Nexus, may help create an environment where customers have a more interactive role in the market. However, for non-daily metered customers the suppliers will not currently know who acted voluntarily or in response to a request. In a situation with widespread interruptions, and high price gas, the resulting compensation costs may fall on only a small group of customers, possibly domestics. This may make the principle worthy, but impractical and/or politically unacceptable. For smaller customers the payment of compensation must not create an unlimited liability on suppliers, with all of the associated business costs, nor must it create a regime that is impractical to deliver without interfering in the competitive supply market.

While the Forum supports the principle of compensation, the liabilities on shippers should be capped so as to ensure that they can continue to operate prudent businesses. If liabilities are uncapped they could put some companies out of business through no fault of their own. Also significant liabilities placed on shippers risks pushing up prices. The price impact may be short term as shippers try to reflect the liability risk in prices today, or the impact may come post emergency where the shippers seek to recover the increased business costs. It would be in line with normal contractual arrangements between companies to have capped liabilities and this principle should be reflected in the gas market.

Obligations – The Forum has considered whether there are any obligations that could be imposed which would provide an economic incentive to act in a way that would reduce the probability of an emergency occurring, or improve the ability of the market to recover from it. Obligations on supplier/shippers to contract for certain volumes of gas may not add any new gas volumes. The majority of the suppliers will be locking in gas for the majority of their portfolios in order to protect against market price/volume risk. Even if suppliers had firm gas supply deals for 100% of their forecast demand, in an emergency it may be of no relevance as the supply disruptions may impact those very contracts. To require suppliers or the SO to hold gas in storage will simply inflate prices. The Forum believes that the storage monitor arrangements are an effective and robust way for the SO to lock gas into store not just in an emergency, but also to create a buffer over periods of extended cold weather, or other supply events.

The Forum believes it is right that the amount of storage in the GB market is driven by market requirements. It is possible to create "strategic storage" and to lock gas in storage sites, as practiced in a number of other Member States. However, such arrangements are costly, limit competition and impact trading. Indeed, Ofgem was keen to remove previous

storage top-up arrangements, which are analogous to strategic storage, as it viewed them at the time as exposing customers to unjustifiable costs which outweighed any benefits which may have accrued. It should be noted that the recent cold weather has seen mid-range storage sites cycling significant volumes of gas, which have helped shippers, and the system, balance and contributed to market liquidity. Ofgem would have to be very clear that stopping or limiting such self balancing type activities would be efficient and economic.

The Forum is also concerned that imposing additional obligations may create barriers to market entry. Not all suppliers will have a credit rating sufficient to purchase storage capacity, they may, instead, have chosen to enter into interruptible customer arrangements in order to manage peak day risks. If Ofgem is minded to increase the obligations on suppliers/shippers we would like to see a full justification as to how this could be in the interests of customers.

Customer Interruption - The Forum supports commercial interruption arrangements. Many of our members have interruptible arrangements with customers, as outlined above.

The Forum is aware that Ofgem has suggested that a review of the interruption regime is not a preference under the SCR, as they see the current arrangements as being related to transportation management and not energy management.

The Forum believes that the previous regime did provide additional customers with the ability to interrupt than the new regime will provide in future (in terms of readiness, internal procedures, etc.). There is a perception amongst customers that firm means firm and that they no longer need to prepare for regular interruption even on peak days. While there are commercial interruption arrangements in place we do not know if the amount of interruption available is reducing due to the change in transportation arrangements.

There is a possibility that an emergency may be triggered through a transportation constraint not energy shortages, with infrastructure most often being the cause of supply restrictions. Overall we suspect that as transporter interruptible customers' volume has reduced so has commercial interruption volume, as the two were very often linked. The Forum recommends that Ofgem undertake a questionnaire to ascertain a detailed view of the volume of interruption capability, as a result of the changes to the transporter nominated interruption regime.

In reaching a decision to alter the interruption regime, the value that these customers were potentially providing to the market, in terms of ability to respond in emergency situations, may have been missed. The benefits would appear to accrue to the whole market, as in an emergency they would help to protect all businesses, a form of un-priced insurance. If customers have picked up the value of their interruption capabilities in commercial contracts

that is to be welcomed, but if they have simply lost interruption capability Ofgem may want to consider whether this needs further consideration.

It may be more economic if the SO were able to contract forward for a more targeted type of interruption, similar to the operating margins type of tender. This could be used to send some investment signals to specific sites, such as newer CCGTs to be built with back-up. However, we note that this may have some interactions with the electricity market reform proposals from DECC and Ofgem will want to ensure that the two regimes work together going forward.

Credit – While mentioned in Ofgem’s consultation, the Forum is concerned that Ofgem needs to understand the credit implications in a situation where gas prices are likely to spiral. While we fully support allowing the market to work as long as possible, we recognise that the ability for parties to trade at significantly higher prices would be relatively short lived. Smaller parties may have particular problems accessing the market at such times and even larger players would likely exceed credit limits.

Players will also need to understand how any dynamic cash-out, without shipper trading, (creating an inability to self balance) will see the costs paid by the SO passed back through the market. In a regime where the SO controls the market, the rules must be clear that the costs will be directed at the customers (for whom the gas is purchased) so that the suppliers’ businesses will not see potentially catastrophic impacts on credit facilities, with bankruptcy and the domino effect of multiple suppliers becoming insolvent being a real possibility. As noted above, the Forum suggests that liabilities must be capped so as to not worsen the position of shippers in relation to their credit positions.

The Forum believes that the credit issue highlights the need for the arrangements to be flexible with a view of the “price freeze” level judged in light of circumstances on the day rather than set in advance. To say now VOLL is say £15/therm may simply create barriers to entry as a new supplier would fear that the market lets suppliers go bust in an emergency despite them acting in a prudent manner, i.e. planning to meet their customers’ needs with contracts for gas, storage, etc...

Transporters – In an emergency where there has been a request to the public to cease gas consumption, the transporters will be best placed to know how requests are being responded to. We believe that they will have a vital role to play in providing timely communications, especially if there are specific regional problems. The regime must make sure that transporters are actively engaged in the emergency arrangements, especially in the way they communicate.

As noted above, the transporters could also help develop a new regime by providing a view on the levels of interruption and the speed of interruption required under a number of

scenarios. Information of this type will help the regime operate more efficiently by improving understanding of system dynamics.

Governance and Implementation

Under an SCR process, and with new powers from Government, we understand Ofgem may define market changes. The Forum members' experience with moving from policy to implementation is that often problems are thrown up that had not previously been considered, or processes do not work as expected. We believe any modifications to the UNC need to be carefully defined so as not to trigger a raft of corrective modifications. One way to achieve this may be to leave the policy solution relatively loosely defined while the business rules, systems, legal drafting, etc. are worked through at an industry level.

The Forum would like to see Ofgem developing its thinking in areas such as the role of demand-side interruption; possibly including a future role for smaller customers as smart metering is rolled out. As noted previously, we would like to focus on arrangements that are practical in a range of emergency scenarios, some where a more dynamic cash-out may work and others where a command and control regime will be needed. We would also like to see more consideration of the settlement process that could work after an emergency.

The Forum hopes these points are helpful in developing Ofgem's thinking. We very much look forward to talking to you about them further in the near future.

Yours sincerely



Steve Gordon
Acting Chair – Gas Forum