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Gas Security of Supply Significant Code Review (SCR) Initial Consultation

Dear Peter,

The new regulatory mechanism of the Significant Code Review (SCR) is focusing on whether reforms to the current gas market arrangements are required to ensure security of supply. As this is the first SCR to emerge from the Code Governance Review, we welcome the opportunity to contribute to the process by responding to Ofgem's initial consultation on the Gas Security of Supply Significant Code Review.

Our response is provided on behalf of RWE Npower plc and RWE Supply and Trading GmbH, and is not considered confidential.

We provide summary points below, and further comments to the section questions in the following pages. We also provide comments regarding the SCR process itself, and have placed these in an appendix at the back of our response.

- The assumption behind this current SCR is that the price in GB would not be sufficiently high enough to bring in further sources of gas from outside GB if there was a gas supply deficit, and that freezing cash out prices in an emergency would prevent prices rising to a significantly high level to attract further gas supplies.

We believe that the current arrangements work well, and that there is no evidence to suggest any changes are required to the regime regarding gas emergency arrangements. We are of the opinion that there is plenty of capacity and flexibility available to the market already, with a diverse supply of gas that has delivered security of supply as demonstrated by the market response to within-day gas balancing alerts (GBAs) in January 2010 and dayahead alerts in December 2010.

As the focus of this SCR is primarily concerned with the emergency arrangements, we seek evidence and a stronger case that change is necessary, and question what has fundamentally changed within the market to necessitate intervention at this time. The Government acknowledges the importance of

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competitive markets to deliver objectives efficiently with minimum cost to consumers and states that markets should be allowed to function where effective. To date, market arrangements have facilitated desirable outcomes and continue to do so, with no indication that this will not be the future case, particularly in the event of a low-probability, high-impact incident such as a *gas deficit emergency* (GDE) within GB.

However, we are of the opinion that if there was to be a major failure, there would be an immediate price spike; a natural effect reflecting the circumstances. Furthermore, in our experience, as soon as NGG take balancing action, prices would rise accordingly.

Declaration of Stage 2 of a GDE by the NEC is a recognition of market failure and as such safety requirements would take precedence over commercial requirements and would govern how an emergency is dealt with. If the market were to fail for whatever reason, it is unrealistic to expect that market forces can be relied upon to resolve the emergency. The principle that safety requirements take precedent over commercial requirements determines how an emergency should be dealt with, and clearly, the *command and control route* is therefore the logical way to solve a Gas Deficit Emergency. There can be no 'one size fits all' option if introducing more commercially led incentives. A GDE can occur through differing circumstances and be *rapid* or *slow-burn* in nature.

- With regards to the suggested options for change to the emergency arrangements, clarification is required on how these or any other variations would fit in with the stages of a GDE. In addition, there is not sufficient information available regarding what the nature or severity of a significant failure would have to be to trigger Value of Lost Load (VoLL).

All options presented in the consultation would introduce the concept of the VoLL into the emergency arrangements. The concept of VoLL as discussed within the consultation, seems to imply that cash-out will be frozen at VoLL rather than being purely dynamic. As VoLL is a new concept, we have a few concerns regarding:

- how this will be determined and set;
- whether capping SMP Buy at VoLL would mean the market would arrive at VoLL quicker than otherwise, because of it being in place;
- would VoLL distort the market mechanisms currently in place, as there is more than one type of emergency that could occur, not a single type of emergency

If market mechanisms are to be relied upon in emergency situations, creating artificial administrative prices for VoLL might not provide a feasible solution.

- We hope that Ofgem evaluates all suggested elements in its forthcoming Impact Assessment whilst engaging further with industry over other potential new option combinations, to ensure no unintended consequences arise later in the process.
- We strongly believe that the current cash-out arrangements already provide robust commercial incentives for shippers to balance. Current arrangements are already creating investment which we see in LNG terminals, increased interconnection and potential storage projects. Shippers are driven by the market and act accordingly; incentives and obligations in an emergency are unlikely to provide the outcome of attracting more gas to GB. It is difficult for shippers to respond to incentives in an emergency unless they fully know what their position is. It is doubtful shippers will have sufficient clarity over their position in such circumstances and we are more likely to see the market cease trading, so market forces cannot be relied on to solve the issues if the market is not operating in an efficient manner.

- If market participants are to be incentivised by possible financial penalties, then consideration must be given to those circumstances under which these penalties would result in serious financial difficulties for those participants, thereby exacerbating problems during an emergency rather than mitigating them. If the intention is to encourage the creation of physical insurance such as storage, against loss of supply, then the cost and practicality of the necessary infrastructure to protect against the low-probability emergency scenarios occurring, needs to be assessed and compared with VoLL. Any physical solutions deemed necessary and essential to security of supply, may be very expensive to put in place and such costs would be passed on to consumers.
- With regards to compensation payments, consideration should be given as to whether the cost of VoLL-based compensation should be borne by all shippers or just short shippers. In principle, the cost should be faced by short shippers although this does increase the risk of shipper failure. Where possible the costs should be targeted at those that have created the situation that needs to be rectified, because having a collective insurance could weaken the incentives on shippers to have arrangements in place to balance their portfolios under extreme situations.

However, in a GDE there could be several complex reasons underlying a number of events, and it may not be a simple process to distinguish between them, for example infrastructure failure or contracts that have not been honoured; clearly an element of targeting costs may still have to be done ex-post.

- Undergoing this Significant Code Review on Gas Security of Supply has raised a number of issues regarding timing and clarity on the need for reform, which needs to be considered in relation to any further SCRs. We are also concerned about the compressed timescale involved that may lead to under-developed solutions being put in place for the proposed delivery timescales.

The Gas Security of Supply SCR process also highlights other areas where attention needs to be focused. The subject of import gas quality is currently absent from the SCR despite being the most foreseeable issue currently which could trigger an emergency, and this will also need to be resolved within the emergency arrangements.

- In the forthcoming Impact Assessment to be carried out by Ofgem, we would like to see due consideration given to costs and benefits associated with all options being considered including who benefits and who pays, safety implications that each option presents, the impact on customers and by different type of customer, the impact on the electricity market, and the potential to avoid an emergency.

We hope our views are useful and if you wish to discuss any aspect of the response, please do not hesitate to contact me.

Yours sincerely,

By email so unsigned

Jill Brown
Economic Regulation

Consultation Questions

Chapter 3

Qu. 1: Have we captured the appropriate range of options for reform of the gas emergency arrangements? Are there are other options that should be considered?

At this stage, reform is being suggested to enhance the current arrangements and we would urge that any changes need to be incremental so that they can be successfully embedded into the current regime.

Any option for reform could encompass a combination of the various elements put forward in this SCR consultation other than the three options suggested by Ofgem. Different arrangements may also need to be considered for different types of emergencies, for example for a *'slow-burn'* or a *rapid* emergency. A slow-burn emergency is one likely to have been developed from a slow decline into the emergency arrangements being invoked, and hence anticipated in advance. The market in this situation would have reached a limit beyond which it is difficult to respond. Alternatively, a rapid based emergency is one where progress from a within-day GBA to a stage 2 occurs quickly over a short period, likely to be during the same day therefore preventing quick responses by the market.

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

We believe that the current emergency arrangements already provide sufficient commercial incentives for shippers to balance prior to an emergency being declared, and for gas from non GB sources to be delivered to the GB market at its opportunity cost. Having a dynamic cash-out price is unlikely to provide an improvement from the current situation. It remains unclear whether any of the options will provide sufficient incentives to increase investment in security of supply.

We question the rationale and evidence for why changes to the current arrangements are required but offer some discussion below on each element of the options presented:

- Element 1 – we believe shipper-to-shipper trading at the NBP should continue under all options, as this will be enable shippers to adjust their imbalance positions during an emergency, to the extent they know what these are. Under options 2 and 3, NBP trading will not be possible via the OCM but should still be facilitated by National Grid.
- Element 2 - with regards to a dynamic cash-out, consideration needs to be given to how this might apply and work successfully under differing emergency situations i.e. rapid or slow-burn, and how to distinguish between the two. For example, a dynamic cash-out price may work for an emergency that arises in a slow manner, whilst under circumstances that lead to a rapid emergency occurring, a freeze on the cash-out price might be more optimal to alleviate the situation. When a steady-state has been achieved within the system, this might then be the appropriate time for the relevant panel to meet and decide on whether the price should be unfrozen and whether to impose a cap. Who should make this decision (e.g. UNC, Ofgem, or others) would need consideration.
- Element 3 – we agree that a post emergency claim process should be unnecessary in the event there is a dynamic cash out element, as shippers should have more confidence they will be paid the opportunity cost of any excess gas they deliver to NGG (from GB or non-GB sources) to balance the system than under the current arrangements.

- Element 4 – if market mechanisms are to be relied upon in emergency situations, creating artificial administrative prices for VoLL might not provide a feasible solution.
- Element 5 – in the event NGG continue to take market balancing actions during an emergency, it is appropriate for these to set cash-out prices. Giving NGG sole purchasing responsibility from non-domestic sources may ensure that more decisive action is taken to relieve the emergency in the event shippers are unwilling or unable, to contract to secure any such gas that is available, although we recognise that NGG may not have the necessary expertise or contacts to undertake such a role.
- Element 6 – Option 1 diminishes the NEC’s role and risks exacerbating an emergency as it prevents the NEC issuing a statutory direction for shippers to maximise their GB supplies, and relies instead on NGG taking market based balancing to incentivise such flows.
- Element 7 – the rules on compensation at VoLL for firm disconnected customers will need verification. We also have concerns over liabilities and socialisation of costs.

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

NGG has statutory responsibilities relating to the safe operation of its network and these should not be amended. We do not envisage NGG being the sole purchaser of gas from non-domestic sources, since it does not have the relevant contacts with supplier companies nor expertise in this area. However, there could be merit in NGG being given sole purchaser responsibility from non domestic sources if this could be shown to lead to more decisive action being taken to alleviate an emergency. This option may also make it easier to facilitate regional co-operation between Member States, as required under the 3rd Energy Package and the new Security of Supply Regulation. To the extent the HSE believes giving NGG this role would materially enhance the current emergency arrangements, it should be considered further, although we are inherently cautious about any change in NGG’s responsibilities that would change its role from residual to primary balancer.

Firm load shedding should be driven solely by safety considerations and the need to maintain adequate pressure within the gas networks, rather than by price.

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

The pros and cons provide a balanced view for each option although we would stress greater emphasis should be placed on the physical nature of an emergency, as it is this that will be paramount over commercial considerations.

Experience also shows that it is difficult to implement Safety Case changes where they are required, and this may impact on the proposed timescale of this SCR.

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

Under option 1, NGG has less certainty where it gives up the ability to direct shippers to maximise supplies and undertakes a mixture of market-based balancing and firm load shedding for safety reasons, which are changes from the current arrangements. We agree that as options 2 and 3 largely retain current Safety Case provisions they may not require a change to the Safety Case.

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

The post emergency claims (PEC) arrangements are untried and assessment and settlement of claims is likely to be onerous and contentious. Under option 1 where shipper-to-shipper trading continues during the emergency, we agree that the PEC mechanism will not be required. Where PEC arrangements are still required, a dynamic cash-out may provide an agreed reference price for settlement.

Chapter 4

Qu. 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?

We are assuming that this question is referring to response to sharper price signals under an emergency situation. A key point here is that market players will have different views of the likelihood of a GDE occurring, as it is a low-probability though high-impact event and it is difficult to mitigate a risk that cannot be anticipated.

We believe that under the current arrangements, an emergency that develops over time will cause prices to rise in response as the supply-demand situation tightens. Gas would be attracted to those markets with high prices, but only where there is a sufficient route available to those markets. If industry does not respond to higher price signals, this is likely to be simply because as much action as possible has already been taken with little room for further involvement from market participants.

For a rapid emergency, the assumption would be the loss of several pieces of infrastructure and it is difficult to make a strong case for building infrastructure, or entering into contingency contracts, on the basis of such an unlikely event occurring.

Qu.2 : What are the likely barriers to attracting gas imports during a gas deficit emergency (GDE)? Could these barriers be overcome?

Although the IUK Interconnector can switch direction within-day in response to price signals, it has to be recognised that gas is not a commodity that can be moved significant distances very quickly and in the short-term this implies that it will be those sources of gas that can respond quicker that will be needed to address the emergency. There will also need to be sustained high prices in order to attract LNG cargoes; again, this commodity can take a long time to reach its destination. Finally, Public Service Obligations elsewhere in Europe have been said to represent a barrier in previous years. However, the greater

transparency over what these are, and the regional co-operation that will be required when developing Preventative Action Plans and Emergency Plans under the new Security of Supply Regulation, should lessen this risk going forward

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

The industry needs to know what obligations are being considered before it can respond effectively. Whether, for example, diversity in buying or more certainty in hedging is the aim. Or are obligations to be placed on physical gas or on NBP trades (with the latter, there is no direct visibility of the physical gas that is being delivered to GB, for example, as trades might be with a financial institution)?

We see that any new obligations are likely to interfere with the market process, with liquidity and competition reducing accordingly as only larger companies are likely to be able to absorb any additional risks and costs. If gas storage becomes an option for consideration, we believe that this would have a negative effect on liquidity and market efficiency by requiring shippers to hold excessive amounts of gas over long and indefinite time periods. Storage obligations or strategic storage are, in our opinion, an inefficient way to safeguard against an emergency, and removing gas from the market in such a manner can only serve to increase market prices overall. With LNG, interconnectors and other flexible capacity available to the market, we believe there is no current economic case for additional storage obligations.

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

We believe that GB already has highly diversified gas supply sources and we question the need for further obligations, as we see them essentially as 'insurance policies', which are likely to be an expensive way of improving security of supply, the additional cost of which would ultimately be passed on to consumers.

Qu. 5: How could obligations be designed and enforced?

We do not support enhanced obligations.

Qu. 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?

Where a mix of price-based mechanisms and enhanced obligations are put in place, shippers run the risk that even if they manage their own position, they may end up paying for others that have not properly covered their risk, in particular where compensation payments are socialised. Placing obligations on shippers would affect market efficiency and could have a detrimental impact on competition and liquidity.

Chapter 5

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

Whilst conducting its Impact Assessment on the range of options presented, we suggest Ofgem also considers how a mixture of the various elements may be more appropriate than the three put forward in the current consultation document. We would like to see due consideration given to :

- What level of security of supply the UK currently has and what level it should have, how it can be demonstrated that any reform has achieved a higher level of security of supply than we currently have, and how might the success of any implemented changes be demonstrated?
- Assessing the UK's role in supporting a regional EU emergency if the UK were to have higher security standards than other EU member States (under EU Reg 994/2010),
- The different potential emergency outcomes, and whether reform of the arrangements would be appropriate for each type of emergency, e.g. *rapid* versus *slow-burn* emergency
- The potential impacts on the electricity market of any changes to the current gas market arrangements.
- Who benefits and who pays, the impact on customers and by different type of customer
- How the costs of an emergency would be shared amongst participants.

Technical Annex

Qu. 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?

If VoLL were to be implemented for all customers, then determining realistic values could be very resource intensive. We would expect VoLL to vary by customer type and industry, and time of year. Furthermore, it is worth considering that the true value of VoLL may only be determined if customers were offered the option to pay upfront for it through their contracts.

It would be difficult to discriminate between consumers on different VoLL levels within a network during an emergency. As safety will be the focus of the NEC, commercial considerations such as VoLL levels will not be of paramount importance in their decision making process; it will not matter if one consumer is on a higher VoLL than another if it is deemed essential by the NEC to isolate that consumer. Perhaps agreement on a nationwide level of VoLL for I&C customers could be a way forward for consideration.

In addition, there is not sufficient information available to indicate what a significant failure would be to trigger VoLL.

Qu. 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 there are benefits in the use of a simplistic method when determining a single VoLL number.

Qu. 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?

Certainly any rules regarding compensation at VoLL for disconnected firm customers would need to be clearly verified, as there are enormous cash flow implications for suppliers if they are expected to carry this out. Questions remain regarding how and where the compensation payments are to come from.

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

We do not have a view on these methods.

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

We believe there is a balance to be considered here: should the cost of a VoLL-based compensation arrangement be borne by all shippers or just short shippers? In principle, it should just be short shippers, but this does increase the risk of shipper failure resulting. However, if the costs are socialised, shippers that have taken appropriate risk mitigation for their own portfolio, e.g. invested in new storage or struck demand side response (DSR) contracts, will still be required to pay. Arguably, this removes the incentive to invest in the first place and on balance, the cost should be faced by short shippers. However, decisions on cost apportionment may best be taken ex-post once the full circumstances surrounding the emergency are known, and the materiality of the costs and their significance on the viability of a shipper's continuing business are also known.

Appendix

We would like to provide comments on the process of this first Significant Code Review following introduction of the mechanism by the Code Governance Review.

- We are concerned that the timescale (six weeks) for carrying out this SCR has been far too short and insufficient to fully debate such an important area both across industry and within company business areas, which has resulted in insufficient time to disseminate the information and allow a proper debate.
- We are also concerned about the compressed timescale involved that may lead to under-developed solutions being put in place for the proposed delivery timescales.
- The weekly regularity of the seminars and workshops has proved challenging to ensure attendance, with insufficient time for presentations and minutes to be completed, commented on and placed on the Ofgem web-site prior to the next meeting. However, when made available, the quality of the minutes has been a good reflection of the content discussed at the meetings.
- Invitation to the workshops should not have been exclusive for a topic that will affect the whole industry.
- The workshops did not discuss the adequacy of the existing mechanisms that are in place. Rather the stance taken by Ofgem has been that the current arrangements are failing and radical change is required.