Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Peter Sherry
Senior Economist
Ofgem
9 Millbank
London
SW1P 3GE

Telephone: 01738 512909
Email: Claire.Rattey@sse.com

Date: 22nd February 2011

Dear Peter

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

Thank you for providing SSE and SGN with the opportunity to comment on the above consultation. We have detailed our answers to the consultation questions in the attached annex; however we have also taken the opportunity to reiterate our high level views below.

In order to ensure security of supply, GB must maintain a diversity of gas supplies, combined with a resilient domestic energy network based on the appropriate balance of regulation and market incentives. The stated objective of this review is to provide enhanced incentives on parties to ensure gas supplies are available at times of system stress and therefore minimise the likelihood of an emergency occurring.

We believe that the current emergency cash out arrangements have represented the correct balance of regulation and market incentives to date. This is demonstrated by the fact that to date GB has not experienced a network emergency. Indeed, in December 2010 GB experienced the coldest month and highest demand level ever recorded, yet customers' demand was met through the market and no emergency situation was invoked. Furthermore, extreme gas prices were not experienced.

However, we recognise that in future the decline in UKCS production and the consequential increased reliance GB will have on imported gas in the coming years, will introduce new challenges for ensuring gas demands are met and security of supply is maintained. If it is hoped that a consequence of this review will be an increase in the level of contracting for physical gas delivered to GB or a move to investment in strategic storage for GB, this is unlikely to be achieved solely through alterations to the emergency cash out regime. In this regard it is important to remember that contracted gas, such as imports via the interconnector, could be unable to be delivered as a consequence of infrastructure failure.

Instead, we strongly believe that the best means of meeting the objectives of this review is through the operation of the market which places incentives on shippers to balance. Shippers will manage the risk of a dynamic cash out price through a variety of means including: contracting for physical supply; storage; demand side response; and NBP contracts. There also needs to be appropriate incentives on National Grid Gas (NGG) as system operator.

We also recognise that because of the nature of gas supply, in that ultimately it does not, unlike electricity, fail safe, there will be a need for a party, currently the Network Emergency Coordinator (NEC) to step in and take control to safeguard the physical integrity and safety of the system, because of the risks and costs associated with the loss of supply at lower pressure tiers. It is for this reason that the existing gas emergency arrangements were put in place and if changes are made to the current emergency arrangements there will be consequences for all industry parties, including safety case implications for all licensed transporters (NGG, NEC, GDNs and IGTs).

We therefore support the following adaptation of option 1:

- The cash out price is dynamic until Stage 3 of the GBE is declared;
- Shipper to shipper trading continues until Stage 3 of the Gas Balancing Emergency (GBE) is declared;
- The current storage monitors are removed;
- Post emergency claims are not required;
- A pre-determined administrative cap on the price NGG can pay for gas, is set at VoLL;
- VoLL is set at a level which takes account of both the cost to customers and the cost to society of the disconnection, in order to provide a sharp price signal;

- NGG can take market balancing actions till Stage 3 of the GBE has been declared, but NGG's actions alone will not set the cash out price;
- If deemed necessary, NGG could be obliged to contract for a specific volume of Demand Side Response (DSR) which would be called upon by NGG at any time up to Stage 3 of the GBE. Consideration would need to be given to whether these costs should be paid for through NGG's SO incentives or feed into the dynamic cash out price;
- At Stage 3 of the GBE, the NEC will take full control of safeguarding the physical integrity and safety of the system. The role of the NEC should not be impinged or undermined by any commercial obligations that could be potentially implemented as a result of this review. It will continue to authorise firm load disconnection; and authorise the instruction of maximum domestic flows from domestic sources;
- If a shipper is in a long trading position when Stage 3 of the GBE is declared, that shipper should receive the full marginal cash out price for their excess gas; and
- If deemed necessary, compensation should be awarded to disconnected customers by their supplier, at a value that reflects the additional costs a customer will face due to the firm load disconnection i.e. Guaranteed Standards disconnection payment level, not the VoLL.

Local Gas Supply Emergencies (LGSE)
Whilst we believe the approach outlined above is appropriate in a GDE, we do not believe that the approach is appropriate in LGSE. As LGSE are likely to result from a transportation constraint i.e. infrastructure failure, rather than a gas deficit, it would be inappropriate to introduce a market based measure to address LGSE. Arrangements already exist via the Gas Standards of Performance Regulations and the UNC compensation arrangements to address LGSE. We request that Ofgem provides confirmation that any arrangements introduced as a result of this review will not be applicable to LGSE. We are concerned that this will have significant implications for RIIO GD1 and the GDNs' safety cases which have not been considered within the SCR.

GDNs act as the system operator of distribution networks during a GDE and take action as deemed to be necessary by the NEC. As has been highlighted throughout the review, the decisions made by the NEC and subsequently GDNs are made purely from a safety and operational point of view. GDNs do not take part in the commercial arrangements during an emergency.

Interruption
As part of the review process for UNC Modification Proposal 0090 the issue of providing a new emergency Interruption product was considered. This was not progressed by Users and was not included in the Impact Assessment carried out by Ofgem prior to the implementation of the modification. Since the proposal became live GDNs now have a clearer understanding of the value that customers put on interruption. It has become evident that customer appetite for interruption is not as widely valued as initially anticipated. This is clear from the number of successful interruptible contracts in place post October 2011. There may be a number of factors contributing to this, but overall it is likely to be underpinned by commercial constraints placed on businesses to maintain production. Ofgem's views on this would be welcome, as well as how an emergency interruption product could be incorporated in the SCR.

Process
We recognise that if a statutory power is introduced that allows Ofgem to direct modification to the emergency arrangements section of the UNC, Ofgem will use that power to introduce any changes in time for Winter 2011/12 if it considers that such modifications will decrease the likelihood or the severity of a gas supply emergency. However, regardless of which proposal Ofgem chooses to implement, if Ofgem does gain this power we strongly urge Ofgem to postpone implementation until at least Winter 2012/13, as we do not believe a full assessment of the options and their implementation can be carried out before Winter 2011/12.

In order to make an informed decision, it is imperative that Ofgem involves all relevant parties in the consultation process and considers all the consequences of any changes fully, including any impact that changes to the gas emergency arrangements could have in the electricity market and the implications for industry credit arrangements. In addition, it is important that sufficient time is allowed to make the necessary changes to support the new emergency regime including those associated with the safety cases. We also believe that the HSE needs to be involved sufficiently early enough in the process given the shift, so that industry participants are able to prepare for the new arrangements.

In conclusion, we strongly believe that the best means of meeting the objectives of this review is through the operation of the market which places incentives on shippers to balance. Shippers will manage the risk of a dynamic cash out price through a variety of means including, contracting for physical supply, storage, demand side response and NBP contracts. There also needs to be appropriate incentives on NGG as system operator.

However, the introduction of a dynamic cash out price will only achieve this objective if the market is allowed to fully function and deliver i.e. no new obligations are placed upon shippers or suppliers; the current storage monitors are removed; and VoLL is set at a level that reflects both the customer and societal cost of disconnection, to provide a sharp price signal.

I hope that our comments are helpful. If you would like to discuss any of the points raised in more detail, please do not hesitate to get in contact.

Yours sincerely

Claire Rattey
**Regulation**

SSE

<u>Annex 1: Consultation Question Responses</u>

<u>Chapter 3</u>

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

No. We note that Ofgem has identified three different combinations of the elements of the GBE arrangements that could be reformed. However, there are many other possible combinations which should be considered, such as the following variation of option 1:

- The cash out price is dynamic until Stage 3 of the GBE is declared;
- Shipper to shipper trading continues until Stage 3 of the Gas Balancing Emergency (GBE) is declared;
- The current storage monitors are removed;
- Post emergency claims are not required;
- A pre-determined administrative cap on the price the NGG can pay for gas, is set at VoLL;
- VoLL is set at a level which takes account of both the cost to customers and the cost to society of the disconnection, in order to provide a sharp price signal;
- NGG can take market balancing actions till Stage 3 of the GBE has been declared, but NGG's actions alone will not set the cash out price;
- If deemed necessary, NGG could be obliged to contract for a specific volume of Demand Side Response (DSR) which would be called upon by NGG at any time up to Stage 3 of the GBE. Consideration would need to be given to whether these costs should be paid for through NGG's SO incentives or feed into the dynamic cash out price;
- At Stage 3 of the GBE, the NEC will take full control of safeguarding the physical integrity and safety of the system. The role of the NEC should not be impinged or undermined by any commercial obligations that could be potentially implemented as a result of this review. It will continue to authorise firm load disconnection; and authorise the instruction of maximum domestic flows from domestic sources;
- If a shipper is in a long trading position when Stage 3 of the GBE is declared, that shipper should receive the full marginal cash out price for their excess gas; and
- If deemed necessary, compensation should be awarded to the customer by their supplier, at a value that reflects the additional costs a customer will face due to the firm load disconnection, not the VoLL.

As the introduction of any obligation within the market will have a direct impact on the effectiveness of each of the options, we do not believe the range of options and obligations should be reviewed separately. For example, as the introduction of an obligation on suppliers to contract or purchase storage capacity could dampen market price signals, the introduction of such an obligation in a market with dynamic cash out arrangements, would be wholly inappropriate. We believe the range of options should be expanded to also include options which contain obligation/s.

**2. Of the three options presented, which do you prefer?**

Dynamic Cash Out

If the objective of this review is to increase the level of contracting within today's market and to encourage the delivery within a GDE of very short term gas supplies such as LNG, we believe this objective will be most efficiently and effectively achieved through the introduction of a dynamic cash out price. Incentives will be sharpest if the market is able to establish the cash out price, rather than just NGG balancing actions; the current storage monitors are removed; and VoLL is set at a level which reflects both customers' and the societal value of maintaining security of supply, in order to provide a sharp price signal.

DSR

If deemed necessary, an obligation could be placed upon NGG to contract with third parties, such as storage operators or gas generators, for a specific volume and duration of supply or load shedding DSR. It should be noted that the volume agreed would not necessarily have to be the full demand of that customer, as allowing a small volume of gas to be supplied would allow essential machinery to continue to run at a low level in order to avoid the need for full start up which could be disproportionately time consuming and expensive.

This DSR could be exercised by NGG at Stage 2 of a GBE to avoid moving into Stage 3. Consideration would need to be given to whether these costs should be paid for through NGG's SO incentives or feed into the dynamic cash out price. If these costs are paid for through NGG's SO incentives, these contracts could be reviewed as part of the wider SO incentives review to assess whether they continue to provide sufficient quantity and duration response to reflect the changing market. We note though that the introduction of such an obligation to the incentives would require a wider review of the incentives to ensure that NGG are not rewarded twice for such contracting.

Compensation

We believe that if compensation is deemed to be necessary, the level of compensation paid to customers should be entirely separate to the VoLL level used in the GBE arrangements i.e. the compensation should be paid by suppliers to their customers, not by shippers. The compensation level should be set at a level which will reimburse customers for the costs associated with their disconnection, not the wider societal costs. As the VoLL level established will need to reflect both the customer and societal value of maintaining security of security in order to provide a sharp price signal, it would be highly inappropriate to require suppliers to compensate customers at this level. Doing so would: create a high barrier to entry; unnecessarily increase customer bills without a GBE even occurring (as shippers will need to pass through increased credit costs); and potentially bankrupt the entire industry in a GBE.

It is not clear why Ofgem believes that a customer would face a different cost level if interrupted for network or energy reasons. If compensation is deemed to be necessary, we believe that the compensation methodology already used by GDNs is appropriate. For domestic and SME customers these arrangements are set out in the Gas (Standards of Performance) Regulations 2008. These regulations limit any individual customer payment to £1,000 for any gas outage greater than 24 hours and also detail a number of exemptions. There is specific exemption covering situations where more than 30,000 customers are affected. Similar arrangements exist within the UNC for compensation for I&C customers. Rather than standard daily payments, the compensation increases proportionally with the capacity held at the individual supply point. The UNC also places aggregate annual limits on the amount of such compensation and also has exemptions for instances where force majeure has been declared.

However, before any requirement to pay compensation is introduced, it should be noted that as the introduction of a dynamic cash out price will already increase costs for shippers, suppliers and ultimately gas customers, (as it is likely that the UNC and OCM credit requirements are likely to be higher), any actions which are not vital to the functioning of the market, and will increase costs further, should be avoided.

We are concerned that Ofgem appear to have provided no comment to date as to how or if compensation should be proportioned between suppliers and GDNs in an emergency situation. We anticipate that GDNs will not liable for payments to customers in the event of an emergency as this would be a significant new financial cost to GDNs that would require additional funding. Should this assumption be incorrect, further discussions with GDNs will be required.

Proposed Options

As highlighted above, we support the introduction of a dynamic cash out price, but our support is conditional upon the market being allowed to fully function and deliver. If compensation is deemed to be necessary, we strongly believe that it should be set at a level that reflects the costs associated with the firm load disconnection, rather than at VoLL. Consequently, as all of the proposed options contain elements which would create barriers to the ability of the market to fully function and deliver, and all feature compensation being paid at VoLL, we cannot support any of them.

We therefore support the following adaptation of option 1:

- The cash out price is dynamic until Stage 3 of the GBE is declared;
- Shipper to shipper trading continues until Stage 3 of the Gas Balancing Emergency (GBE) is declared;
- The current storage monitors are removed;
- Post emergency claims are not required;
- A pre-determined administrative cap on the price the NGG can pay for gas, is set at VoLL;
- VoLL is set at a level which takes account of both the cost to customers and the cost to society of the disconnection, in order to provide a sharp price signal;
- NGG can take market balancing actions till Stage 3 of the GBE has been declared, but NGG's actions alone will not set the cash out price;
- If deemed necessary, NGG could be obliged to contract for a specific volume of Demand Side Response (DSR) which would be called upon by NGG at any time up to Stage 3 of the GBE. Consideration would need to be given to whether these costs should be paid for through NGG's SO incentives or feed into the dynamic cash out price;
- At Stage 3 of the GBE, the NEC will take full control of safeguarding the physical integrity and safety of the system. The role of the NEC should not be impinged or undermined by any commercial obligations that could be potentially implemented as a result of this review. It will continue to authorise firm load disconnection; and authorise the instruction of maximum domestic flows from domestic sources;
- If a shipper is in a long trading position when Stage 3 of the GBE is declared, that shipper should receive the full marginal cash out price for their excess gas; and

- If deemed necessary, compensation should be awarded to the customer by their supplier, at a value that reflects the additional costs a customer will face due to the firm load disconnection, not the VoLL.

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

Dynamic Cash Out
As highlighted in our answer above, if a dynamic cash out price is introduced, in order to allow the market to function it vital that the market, rather than just NGG's market balancing actions sets the cash out price.

DSR
If deemed necessary, an obligation could be placed upon NGG to contract with third parties, such as storage operators or gas generators, for a specific volume and duration of supply or load shedding DSR. Please note that the volume agreed would not necessarily have to be the full demand of that customer, as allowing a small volume of gas to be supplied would allow essential machinery to continue to run at a low level in order to avoid the need for full start up which could be disproportionately time consuming and expensive.

This DSR could be exercised by NGG at Stage 2 of a GBE to avoid moving into Stage 3. Consideration would need to be given to whether these costs should be paid for through NGG's SO incentives or feed into the dynamic cash out price. If these costs are paid for through NGG's SO incentives, these contracts could be reviewed as part of the wider SO incentives review to assess whether they continue to provide sufficient quantity and duration response to reflect the changing market. We note though that the introduction of such an obligation to the incentives would require a wider review of the incentives to ensure that NGG are not rewarded twice for such contracting.

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

As highlighted above, we do not believe Ofgem has identified all of the possible options available for review. As the introduction of any obligation within the market will have a direct impact on the effectiveness of each of the options, we do not believe the range of options and obligations should be reviewed separately. For example, as the introduction of an obligation on suppliers to contract or purchase storage capacity could dampen market price signals, the introduction of such an obligation in a market with dynamic cash out arrangements, would be wholly inappropriate. We believe the range of options should be expanded to also include options which contain obligation/s. Consequently, as there are valid options missing from this assessment, the assessment is incomplete. We were especially disappointed to discover that Ofgem does not intend to publish its IA until later this year.

We do not believe that Ofgem has captured the pros and cons associated with each of the options proposed. One obvious example of this is the proposal that compensation be paid to customers at VoLL. Requiring parties to do so would effectively: create a high barrier to entry; unnecessarily increase customer bills without an GDE even occurring (as shippers will need to pass through increased credit costs); and potentially bankrupt the entire industry in an GBE, yet none of these cons have been captured.

We are also concerned that it appears no analysis has been conducted to date in regards to the implications any alteration to the emergency arrangements will have on other markets. For example, it is important to avoid cross subsidies from one market to the other and to ensure that there are no avoidable knock on effects onto security of supply in electricity.

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

A movement to a dynamic cash out price will require the existing safety cases of NGG, NEC, GDNs and IGTs to be fully reviewed. As the HSE must approve changes to the safety case in the interests of an efficient consultation process, we would urge Ofgem to engage closely with the HSE throughout the consultation process. Furthermore, any proposed alteration to the emergency arrangements, including the impact of changes to the components of each stage will have consequences for many parties which will need to be fully explored and understood.

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

We recognise that the decline in UKCS production and the consequential increased reliance GB will have on imported gas in the coming years, will introduce new challenges for ensuring supply. In light of these new challenges, the current arrangements may run the risk of not providing a sharp enough

price signal to attract supplies to GB in a GDE. We believe that if a dynamic cash out were introduce, the required signals would be provided.

Chapter 4

**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 is no evidence to suggest that the market has delivered sup-optimal security of supply to date. Indeed, in December 2010, GB experienced the coldest month and highest demand level ever recorded, yet customers' demand was met through the market and no emergency situation was invoked. Furthermore, extreme gas prices were not experienced. However, we recognise that in future, the decline in UKCS production and the consequential increased reliance GB will have on imported gas in the coming years, will introduce new challenges for ensuring gas demands are met and security of supply is maintained.

If: a dynamic cash out price is introduced to the GBE arrangements; the cash out price is established by market and not NGG; the current storage monitors are removed; and the VoLL is set at a level which takes into account both customer and societal cost of disconnection; we see no reason as to why the market will not respond to sharper price signals.

Ultimately, if the market is not able to deliver, the GBE will move to Stage 3 at which point the NEC will exercise command and control and firm load shedding is initiated. This should provide sufficient incentive on shippers to ensure that they take action to help the system in times of distress. However, if Ofgem have concerns that there may be situations in which the market may not deliver, these could be overcome by placing an obligation upon NGG to contract with third parties for DSR, as highlighted above.

It is worth noting though that as highlighted above, the introduction of a dynamic cash out price is likely to require the UNC and OCM credit requirements to be increased. If a shipper's credit limit is decreased as a result of this change in the GBE arrangements, it may prevent the shipper from being able to purchase supplies it would previously have had access to.

**2. What are the likely barriers to attracting gas imports during a GBE? Could these barriers be overcome?**

The three main barriers to attracting gas imports during a GDE are: import infrastructure capacity; the price other markets are willing to pay for gas; and the distance the source of gas must travel to GB, i.e. it could take an LNG tanker coming from Trinidad over a week to reach GB.

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

As highlighted above, if Ofgem have concerns that there may be situations in which the market may not deliver, these concerns could be overcome by placing an obligation upon NGG to contract with third parties for DSR.

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

As highlighted above, if deemed necessary, an obligation could be placed upon NGG to contract with third parties for DSR.

**5. How could obligations be designed and enforced?**

As highlighted above, NGG's DSR obligation could be exercised by NGG at any stage up to Stage 2 of a GBE to avoid moving into Stage 3. As these contracts would provide an industry wide benefit, we believe it would be appropriate for NGG to claim the cost of such contracts back through their SO incentives and feed into cash out price. These contracts could be reviewed as part of the wider SO incentives review to assess whether they continue to provide sufficient quantity and duration response to reflect the changing market. We note though that the introduction of such an obligation to the incentives would require a wider review of the incentives to ensure that NGG are not rewarded twice for such contracting.

**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?**

As the introduction of any obligation within the market will have a direct impact on the effectiveness of each of the options, we do not believe the range of options and obligations should be reviewed

separately. For example, as the introduction of an obligation on suppliers to contract or purchase storage capacity could dampen market price signals, the introduction of such an obligation in a market with dynamic cash out arrangements, would be wholly inappropriate. We believe the range of options should be expanded to also include options which contain obligation/s.

It should be noted that if an obligation is introduced where unnecessary, it will impose additional unnecessary costs upon shippers and ultimately gas customers. As the introduction of a dynamic cash out price will already increase costs for shippers, suppliers and ultimately gas customers, (as it is likely that the UNC and OCM credit requirements are likely to be higher), any actions which are not vital to the functioning of the market, and will increase costs further, should be avoided.

Chapter 5

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

No. Please refer to Chapter 3 question 4.

Technical Annex

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?**

We believe the VoLL level would need to be set at a level which reflects both customer and societal value of maintaining security of supply, in order to provide a sharp price signal. Therefore, we believe only one level that encompasses all parties, is appropriate.

We also doubt whether the current external and internal Settlements systems are be able to manage two separate VoLL levels, without heavy additional investment. As highlighted above, it should be noted that as the introduction of a dynamic cash out price will already increase costs for shippers and ultimately gas customers, (as NGG will be required to increase their credit requirements), any actions which are not vital to the functioning of the market, and could increase costs further, should be avoided.

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?**

As highlighted above, we believe one level that encompasses all customers to be appropriate.

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?**

The compensation payments should change with the duration of the interruption, in line with the compensation methodology already used by GDNs. For domestic and SME customers these arrangements are set out in the Gas (Standards of Performance) Regulations 2008. These regulations limit any individual customer payment to £1,000 for any gas outage greater than 24 hours and also detail a number of exemptions. There is specific exemption covering situations where more than 30,000 customers are affected. Similar arrangements exist within the UNC for compensation for I&C customers. Rather than standard daily payments, the compensation increases proportionally with the capacity held at the individual supply point. The UNC also places aggregate annual limits on the amount of such compensation and also has exemptions for instances where force majeure has been declared.

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

We believe the VoLL level must be set at a level, which reflects both the customer and societal value of maintaining security of supply, in order to provide a sharp enough price signal. The value given to the customer costs could reflect the level established under the existing 'Guaranteed Standards' methodology. The societal value will be an arbitrary figure, but could possibly be based on GDP.

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

As the level of compensation paid to customers will be entirely separate to the VoLL level used in the GBE arrangements i.e. the compensation should be paid by suppliers to their customers, not by

shippers, suppliers will be responsible for paying compensation to their customer which are disconnected.

However, as highlighted above, Ofgem must give consideration as to how or if compensation should be proportioned between suppliers and GDNs in a GBE situation. We anticipate that GDNs will not liable for payments to customers in the event of an emergency as this would be a significant new financial cost to the GDNs that would require additional funding. Should this assumption be incorrect further discussions with the GDNs will be required.