

Ofgem Significant Code Review: Gas Security of Supply

Tata Steel¹ Response

We respond to Ofgem's proposals as a major user of natural gas across our UK steelmaking and manufacturing sites. We support the spirit of the review but are unable to commend any one of the proposed options since it has not been demonstrated that the outcomes would be as intended or that those outcomes, if they were to eventuate, would be consistent with the long term interests of Tata.

Specifically:

- We have a concern that the market-driven approaches outlined in Option 1 and 2 would fail to bring about tangible improvements in security of supply.
- The security of supply standard to be achieved is unclear and the interaction with EU Member States is uncertain
- We do support further development of those aspects of Ofgem's proposals that are of direct relevance to consumers (VOLL and System Operator led DSR).

Those who attended the recent SCR workshops questioned the need for Ofgem's current review by highlighting the positive supply and demand balance achieved during recent historical demand conditions. In the longer term we continue to have concerns that security of supply can be assured to the same degree for the following reasons :

- Sufficient levels of LNG supplies arriving in the UK market cannot be guaranteed in the long term
- Year on year reductions in the availability of indigenous supplies are inevitable
- Gas storage capacity is out of line with other European markets
- Parallel European PSOs may limit availability to alternative continental storage during periods of peak demand

We therefore support Ofgem's current review. We make general comments on those aspects which are of direct relevance to Tata as follows:

¹ About Tata Steel in Europe

The European operations of Tata Steel (formerly known as Corus) comprise Europe's second largest steel producer. With main steelmaking operations in the UK and the Netherlands, they supply steel and related services to the construction, automotive, packaging, material handling and other demanding markets worldwide. Tata Steel is one of the world's top ten steel producers. The combined group has an aggregate crude steel capacity of more than 28 million tonnes and approximately 80,000 employees across four continents.

Value of Lost Load (VOLL):

Use of VOLL as compensation for firm customers disconnected: Ofgem make two proposals (Option 1 and 2) to unfreeze cash-out which we support. Under the proposals an incentive is placed on suppliers to manage their exposure to potential compensation payments valued at VOLL.

We understand suppliers are concerned that dynamic cash-out combined with compensation payments pose an unquantifiable risk on their businesses. Subject to Ofgem's response to these arguments our converse view is that using VOLL as a transparent administrative cap risks increasing cost unnecessarily to consumers; suppliers may be more inclined in their pre-emergency behaviour to cover their exposure to VOLL via insurance/financial techniques that have little to do with tangible improvements in the security of supply.

Methodology for determining VOLL for compensation: We are concerned that Ofgem's proposals regarding VOLL are simplistic. The fixed sum approach ignores the scale of lost load and the temporal nature of our business risks ie. the value of the loss of manufacturing changes over time and by the processes or products affected. In the case of Tata, for example, the threat of unscheduled load shedding is less likely to lead to fuel switching than to the cessation of production and consequent damage to capital plant. For these reasons VOLL as currently presented is unlikely to compensate us for the full loss of manufacturing. The SCR workshops did not distinguish between direct and indirect losses which are important when considering liability for compensation.

Demand Side Response:

Ofgem acknowledges that the market may not function when supply is scarce. Interventions such as interruption or firm load shedding are expected to compensate for this. However the flexibility provided via DN interruption will not be available in significant quantities from October 2011. Secondly, forcing industrial load off the system without compensation is fundamentally unfair as this puts industry in the position of acting as the 'insurer of last resort' despite the fact that industry is the least likely participant in the market to contribute to the supply shortage. In this context we are pleased Ofgem now accepts that forced load-shedding of industrials warrants compensation and that further efforts should focus on preventing this scenario.

In the absence of any other mechanism for compensation being available to industry, Tata has previously attempted to contract ahead with suppliers to secure the best price for gas in the event of our being asked to firm load-shed. Our experience of these discussions confirmed that the values on offer ahead of time with suppliers did not reflect the loss of production. Additionally, the products on offer assumed that customers would bear the supplier's cash-out risk.

Some end-users may now have access to commercial tools to permit more direct access to wholesale markets, but these may be of limited value when supply is scarce. Users may have taken the appropriate risk management decisions to protect against price shocks. In such circumstances we anticipate commercial tensions over which party has title of gas, particularly if the customer has exposure to the day ahead market. Ultimately only suppliers may see direct benefit in reducing load.

We cannot comment on the position of other DM users but a review by Ofgem of this relatively small number of supply points may prove illuminating. Such a review could also confirm the level of fuel switching capability that will be retained by industry after the change-over to firm status from October 2011. For the record, for some industrial sites including our steelmaking facilities there are technical reasons for having no alternative fuels for critical load, eg. the requirement for superheating or that certain industrial sites may be classified as top tier COMAH status where installation of back-up fuel raises additional risk scenarios.

Development of 'Last Resort Mechanism': The one area of unanimity at the SCR workshops was for National Grid to develop a last-resort DSR mechanism. We envisage the System Operator would be able to secure a facility for industrial load to reduce use in order to reduce the likelihood of the supply/demand position deteriorating further.

Whilst we have some reluctance in debating a product that allows firm load interruption at a price we recognise this would be of value in mitigating the risks of full firm load shedding. We envisage this product would be an extension of the existing Gas Balancing Alert.

National Grid would contract and communicate directly with the demand-side to reduce the consumer's firm load in tranches. Communications would be managed by NG to underline the gravity of the position being managed (rather than commercial balance within a shipper's portfolio) and provide some additional certainty to the demand-side that contracts would only be exercised *in extremis*.

Contrast with Contingency Procedures: The communication channels in this event would be short and would bring about a robust mechanism for pre-emergency response. Of most importance is that it could help correct the iniquity of current firm load emergency arrangements whereby largest users are called off first and to their full load ie. calling off the largest users completely, irrespective of how much load is required over what timescales and/or the response time required.

A layered approach in pre-emergency conditions would be much more acceptable. It would engage all DM users in emergency planning and will make any final response more robust whilst maintaining some assurance of business continuity post-event.

Obligations:

As a basic measure of success we would expect to see a demonstrable improvement in security of supply. In order to do this Ofgem need to understand suppliers' sourcing strategies and risk management practice. We were disappointed that Ofgem had difficulty making these assessments from data recently provided by suppliers. Licence requirements may be appropriate here so that suppliers provide sufficient information in a form for Ofgem to make these assessments - a measure of 'secure supplies via diversified sources' could become part of suppliers' competitive offering to customers.

A second potential obligation was greater involvement by the System Operator in contracting for last resort demand-response. It would be important to ensure that any contracts here were not triggered unnecessarily by mechanistic rules, as may be the case with the existing GBA facility. These contracts should not be seen as just another market instrument.

Storage-related mechanisms were the final area for review. It is our firm opinion that these still warrant further review, either in respect of top up mechanisms or of minimum storage stock obligations, (the latter could be demonstrated from mainland European assets, incidentally.) Group members alluded to other ways of stimulating storage, not just via PSOs, and, if this is the consensus view from the supply market, we would value wider understanding and acknowledgement of these alternatives.

We hope you find these comments helpful and constructive. We look forward to continuing developments in this area.

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