Minutes

Gas Significant Code Review — Draft Policy Decision Workshop 1

Date:	Tuesday, 13 December 2011
Time:	9:30 – 12:30
Location:	9 Millbank, London

1. Opening presentation

1.1. Anna Barker opened the workshop by presenting Ofgem's thoughts on a number of issues concerning implementation of the cash-out reforms proposed in the Draft Policy Decision document.

1.2. Anna stressed that while we are keen to consider the detail of how our proposals could be implemented, this does not mean that we would be progressing with these reforms irrespective of the consultation responses received.

1.3. She provided attendees with a recap on the draft policy decision and gave an overview of a number of issues that had been identified in relation to implementation of the proposals. She indicated that these issues would be discussed in more detail in the break-out sessions.

2. Break-out sessions

2.1. In order to ensure that stakeholders were able to discuss all of the issues identified and in a sufficient amount of detail within the time available, Ofgem invited attendees to choose between two separate break-out sessions.

2.2. The first of these focussed on the cash-out process including implications on the Gemini system, options for timing of the cash-out process in the event of an emergency and credit issues.

2.3. The second focussed on the practical issues around the use of neutrality and payments for involuntary demand side response (DSR) services, how to deal with interruptible customers in an emergency and payment for non-daily metered (NDM) customers who may be affected by firm load shedding.

2.4. It was noted that if there was sufficient time in each of the break-out sessions then the issues being focussed on in the opposite session may be discussed.

Break-out group 1

Options for the cash-out process

2.5. Attendees in this group considered two options for dealing with Ofgem's proposed cash-out reform. It was noted that these two options were deliberately put forward as the two extremes at either end of a spectrum of options and that the actual method for dealing with this may lie somewhere in the middle.

2.6. The first option considered was a near-time option in which the cash-out price would rise to the Value of Lost Load (VoLL) (estimated at £20 per therm) as soon as the first firm load customer was interrupted and as much as possible would be done near to the actual emergency event including calculation of imbalance positions based on daily metered (DM) customer meter reads and estimates of NDM customer demand. A reconciliation procedure would then be performed at a later date once actual NDM customer demand data became available.

2.7. At the other end of the spectrum was a post event process in which the cash-out price may be temporarily frozen following an emergency before all data regarding actual DM and NDM customer demand became available. Once all data was available, actual imbalances would be calculated, priced at VoLL and reconciled for the amount paid at the frozen cash-out price.

2.8. Stakeholders broadly agreed with the pros and cons set out by Ofgem in their hand-outs for the break-out session. The main arguments that were put forward regarding the near-term option were that it could be impractical and could have the unintended effect of taking away the focus of key personnel from managing the emergency. In addition, it was thought that the potential for a sudden hit could exacerbate credit issues.

2.9. Contrary to this, other stakeholders suggested that the credit impacts could be greater under the longer term option given the uncertainty around the ability of some shippers to remain in the market during this time despite potentially being liable for such amounts as to make them insolvent once payments were due. Others had concerns that the cash-out price would be providing 'fake' signals when frozen and could raise the risk of gaming in the market.

2.10. Given the pros and cons identified for each option, there was no clear steer towards either of the two.

Symmetrical cash-out

2.11. One attendee suggested having a single cash-out price of VoLL for both long and short shippers. It was proposed that this could increase price certainty for long shippers which could increase the incentives on shippers to bring gas onto the system. It was also suggested that having VoLL for long shippers would mean that the Post Emergency Claims process could potentially be removed.

2.12. However, there was general agreement that this may have a significant impact on incentives to trade out positions through the market. In addition it was suggested that, other than for the first day of a rapidly escalating emergency, one may expect the system marginal sell price (which would be derived by the system average price) to increase up to close to VoLL anyway and that this would provide similar incentives.

VoLL as a target price

2.13. Concerns were raised from some attendees that applying an effective cap on the cash-out price at £20 per therm may act as a 'target price' for shippers who may withhold gas in order to push up the price before supplying it when the price hits £20 per therm.

2.14. It was agreed that in order to achieve this, the relevant shipper would need to be in a position of significant market power but it was considered more likely that this may be the case under emergency conditions than during normal operation.

2.15. Ofgem asked whether if option one in the draft policy decision had been chosen this could mean that £280 per therm would act as a target price. While there was a lack of consensus, a number of attendees thought that a cash-out price of £280 per therm would be less realistic as a target and so not provide the same incentives to deliberately push up the price.

2.16. Ofgem reiterated that VoLL was not so much supposed to be a cap but instead ensured that the cost of DSR was factored into the system balancing costs. Ofgem noted that ideally it would have been good to have made cash-out dynamic but that this was not possible given safety considerations.

VoLL could mean fewer consumers agree interruptible contracts

2.17. It was noted by attendees that an important part of Ofgem's proposals was to encourage large gas consumers to sign up to interruptible contracts as a way of encouraging DSR ahead of an emergency. Attendees suggested that it may be difficult for suppliers to negotiate interruptible contracts given that consumers would otherwise receive £20 per therm if they were disconnected in the absence of an interruptible contract.

2.18. Ofgem replied with the view that interruptible contracts could be encouraged if suppliers were willing to provide attractive terms to consumers. For example it was suggested that an option payment could be offered as a regular discount on the consumer bill in addition to, or instead of an exercise payment in the event that a consumer was disconnected.

2.19. Ofgem suggested that because of the potentially large payments that would need to be made to large consumers in the event of disconnection in the absence of an interruptible contract, and because of the greater risk of wide reaching disconnection without more structured DSR, the industry would have reasonable incentives to offer appropriate terms to consumers. However some attendees did not believe that this objective would be met as effectively as expected by Ofgem. Ofgem noted that DSR options were also to be considered as part of the further interventions workstream.

Force majeure

2.20. Some attendees suggested that force majeure should be applied to interruption payments (which may lead to force majeure also being applied to the cash-out price terms in some way) for certain circumstances surrounding an emergency. One attendee pointed out that force majeure terms were applied to physical gas contracts but not to the National Balancing Point (NBP). Hence, if force majeure did not apply to cash-out this might provide a perverse incentive for players to leave the physical gas market and instead trade on the NBP instead.

2.21. Attendees did not suggest that force majeure should apply to all extreme conditions but to a limited number of well defined circumstances. For example, it was proposed that force majeure could be tied to the European Union Gas Security of Supply Regulation by applying an N-2 measure (ie force majeure would apply when Great Britain's two biggest items of infrastructure were out of service at the same time).

2.22. Ofgem responded by raising concerns that force majeure could dampen incentives on the industry to take all actions possible to avoid an emergency occurring or to bring in extra gas during an emergency if force majeure had been declared. Further, on the physical market point it was suggested that unless the force majeure applying to cash-out and interruption payments was the same as that applying to physical contracts it might not be effective. In practice it would be difficult to ensure that these were the same as force majeure might change from contract to contract in the physical market.

Credit implications

2.23. Attendees were concerned with the implications that the proposals could have on credit requirements ahead of an emergency and whether this may raise barriers to entry which may negatively impact on market liquidity. In addition, concerns were raised that the proposals increase the risk that in an emergency, shippers might not be able to cover their liabilities and that this could lead to a domino effect since the rest of the industry would have to cover the shortfall.

2.24. In order to get a better idea of the potential credit implications and their effect on the market, attendees were keen to hear the views of xoserve and the Energy Balancing and Credit Committee to get an idea of the level of credit that may be required by the industry.

Paying neutrality imbalance

2.25. Attendees were asked for their opinions regarding how any imbalance between the payments into neutrality (or some other process) of short shippers and payments out for interruption payments, long shipper payments and any National Grid Gas (NGG) actions (eg Emergency Curtailment Quantity (ECQ) payments) should be covered.

2.26. It was suggested that there were three potential options:

1. This imbalance could be covered through neutrality as normal with costs being covered by the industry based on throughput.

2. The imbalance could be targeted at short shippers only.

3. The imbalance could be covered through a reduction in interruption payments to interrupted firm consumers (ie consumers would not receive £20 per therm for their interrupted load but would receive their share of the total payments in (based on level of load reduction) after other payments out had been made).

2.27. Attendees showed a clear preference for the third option in which consumers would likely be paid less than the £20 per therm. They considered the first option problematic in that long shippers would be punished to a certain degree (as they would be likely to have a larger throughput and so have to pay a larger proportion of the imbalance) which could dampen incentives to ensure a balanced or long position. They considered that targeting these costs at short shippers under the second option could overly punish short shippers and increase the risk of these shippers defaulting on their payments (which could ultimately affect the rest of the industry). However, we note that no consumer representatives were present in this break-out group.

Break-out session 2 issues

2.28. Before starting the discussion on the implementation of cash-out reform, several attendees wanted to discuss the draft policy decision. The following points were raised:

- Shippers were concerned about the credit impacts of cash-out reform. In particular, it was argued that profit margins of shippers are too low to pay such high cash-out prices. Hence, some shippers would be forced out of business in an emergency. This could have a domino effect on the entire industry since the industry would have to pick up the tab through neutrality.

- One attendee questioned whether the proposed system represented the least cost to both consumers and industry or whether, for example, Public Service Obligations would have more advantages.

- Shippers also noted that the draft policy decision could result in a large number of mods being raised and judicial reviews being launched to try and reverse the implementation of the Gas Significant Code Review. They also added that domestic suppliers might be placed at greater risk, because unlike suppliers with industrial and commercial customers, they would not be able to agree interruptible contracts with their customers.

Cash flow – whether to use neutrality or create a dedicated fund

2.29. Ofgem presented two extreme options on how cash-out from short shippers could potentially be used to pay for involuntary DSR payments. In the first option, the existing neutrality system would be used and modified. In the second option a new dedicated fund would be introduced to collect cash-out payments from short shippers and to pass this on to interrupted consumers. In the former, any fund imbalance (resulting from payments from short shippers being more or less than that required to cover the involuntary DSR payments) would go through neutrality. In the latter, any imbalance would be targeted at short shippers.

2.30. The point was made that there are difficulties with establishing who would be short on the day. In particular, there was concern that shippers might appear long and their credit requirements would subsequently be less than was ultimately required. Shippers might trade out their imbalance (ie reduce their long position) and be subsequently hit hard once their real imbalance is clear.

2.31. Therefore, attendees appeared to favour a process which would suspend neutrality during an emergency, with settlement taking place offline and at a later stage once all required information was known. A dedicated fund could then be set up to collect the short cash-out payments and organise payments to interrupted customers. There was a question about who would run the dedicated fund.

2.32. Some shippers argued that it might be more sensible to smear any remaining imbalance across the industry since short shippers will already be hit hard and might be unable to pay for this. In general however, shippers seemed in favour of limiting payments to interrupted customers to the total amount collected through short cash-out payments. This would mean that customers might potentially receive less than VoLL under this approach.

Payments to interrupted NDM customers at stage 2 of an emergency

2.33. While it is relatively straightforward to assess the load reduction of DM customers that have been asked to interrupt at stage 2 of an emergency, it is more problematic for NDM customers. In particular large NDM customers could be asked at this stage to stop consuming gas but there is no way of assessing that they have reduced their demand. Hence, there is a question about how those customers would be paid for reducing their demand during firm load shedding.

2.34. Ofgem presented two options for the burden of proof that NDM customers have reduced their demand during firm load shedding. Under one option, NDM customers would be paid for reducing their demand unless their shippers could prove that their customers had not reduced demand. Hence, the burden of proof would be on shippers. In the other option, NDM customers would only be paid for reducing their demand if they can prove that they have done so.

2.35. There was general agreement that the automated meter read (AMR) roll-out to be completed by 2014 should help to address this issue. In the meantime, shippers argued that as consumers usually pay for the AMR equipment the burden of proof should be on consumers to prove that they have reduced their demand. This approach was also supported by the consumer representative present. It was noted that the information required to constitute proof of a reduction in load would have to be agreed in advance.

Payment to interruptible customers if interruption is directed by NGG

2.36. The last issue discussed in the break out group was around the treatment of DM customers with interruptible contracts. In particular, there is a question about what to pay such customers and how to reimburse affected shippers should the interruption be a result of a NGG order.

2.37. Ofgem were interested to know if the group felt that, under these conditions, a DM customer should be paid at the agreed exercise price or whether they should receive a payment of VoLL. Further, there is a question about what affected shippers should receive from short shippers to pay for the payments to customers. Finally, Ofgem raised the question about how affected shippers should be compensated, if at all.

2.38. It was noted by shippers that this issue was crucial if the cash-out proposals were to work. One shipper suggested that consumers should receive the exercise price, while shippers should receive VoLL. Further, it was questioned whether the current ECQ process is working or whether shippers should not also be able to sell gas on the market rather than receiving the System Average Price of the last 30 days.

2.39. Other attendees felt that it was important to highlight that consumers are not interested in providing DSR services. Others pointed out that, going forward, consumers who wanted to be firm might have to pay a higher price.

3. Reporting back

3.1. Both groups reported back on their findings. Stakeholders were keen to note that a large number of different possible mechanisms had been discussed during the workshops so far. It was noted that this would hinder the ability of parties to respond to the consultation. It was asked that greater clarity be provided about the potential mechanisms to be used before the next workshop so that stakeholders can factor this in when responding in writing to the draft policy decision by 31 January 2012.

3.2. Anna Barker thanked attendees for their contributions and noted how important these sessions were for getting stakeholder engagement and input. She also stated that Ofgem will consider how to provide greater clarify on the implementation issues before the next workshop.