BG GROUP

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Ofgem
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Dear Anna,

Gas Security of Supply – Significant Code Review Draft Decision

We welcome the opportunity to respond to the Significant Code Review (SCR) consultation. Might I also add how much we welcome the interaction that we are afforded on this matter through both the workshops during 2011/12 and the bilateral meetings on DECC's "other measures". The industry / Ofgem discussions over the last year on SCR have been well conducted and informative and, from these wider interactions, we hope you clearly understand our base position: namely, support for ensuring that appropriate measures are put in place to improve GB's gas security of supply.

However, we do not agree with the conclusions or some of the market analysis in the SCR draft-decision document and, hence, strongly oppose the isolated application of the SCR as proposed. Indeed, on its own, we do not believe the SCR is sufficient to bring either new storage or other supplies to the GB market. Furthermore, through unintended consequences, the SCR is likely to lead to distortions in the NBP market with exaggerated price responses that harm security of supply, are detrimental to all consumers and cause significant credit jeopardy to market participants.

Summary

Reflecting the attached diagram, we would request that Ofgem:

- Take an integrated view on security of supply and defer a decision on the application of the SCR proposals until all issues are identified and the most appropriate combined solutions can be applied. This will ensure that the lowest cost solutions can be put in place for GB.
- Recognise the need to ensure that the costs to be borne by the consumer in improving security of supply must be transparent and appropriately targeted on exit.
- Burst the "hype" and expectation raised by the SCR's £20/th VOLL cash-out price. This is detrimental to getting effective, economic solutions in place, both on supply and demand.
- Work with National Grid and industry to develop an effective Demand Side Management auction. This is the primary necessary step to averting a Gas Deficit Emergency (GDE) and gives NGG control over where to shed load to best manage and prevent the emerging emergency.
- Retain Post Emergency Claim process, dual cash-out and ensure that SAP continues to be dynamic during an emergency (but keep NGG's SMPb price frozen at Stage 2)
- Consider how a minimum stockholding obligation can be used to provide additional security of supply over time. If such a solution were to be proposed by Ofgem, it would need to be flexible (location, type of physical supply) and scalable (reflecting supply demand conditions over time). Such a proposal might underpin new storage capacity investment in GB markets.

Types of Emergency

The GB market may face two types of emergency; one that can be anticipated (so called "slow burn") or a sudden or rapid emergency associated with successive failures at major pieces of supply infrastructure (which we would further differentiate between when the Bacton-Zeebrugge Interconnector is either in export or import mode). In the event of a "slow burn" emergency, such as significant disruption to LNG supplies to GB market, the gas price will rise ahead of the deficit materialising and measures (increasing alternative supplies and reducing demand) should avert the emergency. If there is a sudden emergency then it will take much faster physical responses to avoid the impending GDE.

Why does the SCR proposal not work?

We do not consider that £20/th VOLL is either justified as an appropriate price to reflect security of supply, nor, and more importantly, do we consider it sufficient on its own to deliver additional security of supply through new storage or other physical contracts. We do not believe that there should be a cap (or higher of approach) and do not think that NGG's balancing actions should be extended beyond the time when the GDE is invoked.

The £20/th VOLL reflects Ofgem's small sample assessment of domestic consumers' willingness to pay to avoid loss of supply. Given that the average domestic household's peak daily consumption is over 4 therms per day, we believe that this level (£80/day) is excessive. A similarly small sample size reported by CEPS[1], to which we had drawn Ofgem's attention, gave significantly lower values that we believe to be more representative.

The main problem with seeking to keep the market open for National Grid Gas to continue to set marginal buy prices is that it is very unlikely to attract any more gas to the GB market to avert a rapid emergency. As prices escalate, so trading will be come sparse and "gappy" - the GB market experienced this in December 1999 when SMPb reached £4.97/th. Given that the cash-out price will be the higher of SMPb and £20/th, the £20/th will act as a target for traders and prices will quickly escalate to that exaggerated price level. Since gas flows over a 24hr period, those bringing in physical gas are likely to be risk-averse in selling within day because at the end of the trading "day" (6pm), there is still half the gas due to be delivered. This is definitely not to say that gas would be withheld from the system; rather that there is likely to be caution in how it is placed, (ie near levels at which prices are likely to close.

The £20/th also represents a disproportionate risk to shippers, either through direct cash-out risk or, more likely, through credit exposures where there is socialised cost of another, less prudent party's default. This risk would make the GB market materially less attractive to participate in and it is unclear how this increased risk would translate into higher prices for the end user. It is therefore important that, if Ofgem is seeking to improve the security of supply for the firm end user, that there is clear transparency of the costs and that they are targeted at consumer (exit) charges.

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1 CEPS "Consumer Valuation of Energy Supply Security: An Analysis of Survey Results in Three EU Countries http://www.ceps.eu/book/consumer-valuation-energy-supply-security-analysis-survey-results-three-eu-countries

Our approach to developing a Security of Supply safety net

Given the comments above, we would request that Ofgem and DECC examine the security of supply risks holistically rather than treating SCR independently from the "Other measures". By taking this approach, Ofgem, DECC and consultees are likely to find the best solutions to avert a GDE. We understand that Ofgem are proposing to identify the remaining residual Security of Supply risks after the application of SCR. We disagree with this approach and believe that all the risks should be clearly identified and then solutions put in place. By doing so, we believe the appropriate, robust solutions can be put in place at the lowest cost to the consumer. To be explicit, we do not believe that the SCR proposal would feature in such a solution, as it is neither desirable nor necessary.

It is important to acknowledge that improvements in firm consumer security of supply will need to be paid for by those consumers who will enjoy the benefit of improved security of supply (ie: those firm consumers who will continue to take gas). Having taken a holistic view of the risks and solutions, it should be easier to calculate the incremental costs associated with the improved security of supply and these costs should be targeted to consumers *via* exit charges. It is not acceptable to believe that the SCR proposal will provide insurance at the shippers' own costs. In reality, the SCR will simply increase market-risk for shippers and make GB a less attractive place to invest, potentially to the detriment of improvements in security of supply!

We would therefore recommend that the time being devoted in Q1 2012 to future SCR workshops on changes to the UNC and NGG Licence be used by Ofgem and the industry to work on the "Other measures" element and develop a full set of the risks. There can then be further discussion on the appropriate solutions in Q2 2012, but for now, our proposals would include the following elements:

Demand side Reduction Auction

Large daily metered users, who are able to shed part or all of their load are going to be essential in helping the GB market avoid a GDE. Rather than having suppliers contracting for commercial interruption in the event that a GBA is called, we favour NGG having a central contracting role. This approach has a number of benefits:

- NGG would be able to adopt a "command and control" approach so that demand load can be shed where it helps alleviate the problem – if shippers were to interrupt load in Scotland when the problem is in the South-Wes, this would be much less effective and perhaps generate unnecessary costs and unnecessary inconvenience to end users.
- End users are likely to have greater trust in NGG than in suppliers who may change on an annual basis.
- An auction where end users are able to offer demand load shedding in tranches or full site, would provide NGG with a "merit order". An initial "annual" auction, ahead of the winter, is probably the best solution so that the anticipated load-shedding volume is known but there may be the need to refine the offers as the winter goes through. Customers are likely to face changing circumstances in their underlying business as well as in base commodity prices.
- Costs for this service (option payments to consumers), and when it is called off, can be incorporated into an exit-charge smear.

Post-Emergency Claims

Whilst the detailed workings of Mod 260 have never been tested, we consider that the arrangements to claim a price above the SAP price are workable, in spite of the uncertainty it presents to those providing incremental gas. If, when used in anger, there was any reneging on the price for appropriately claimed supplies that were delivered into the GB market, then this would prove to be detrimental to GB's security of supply in the longer term.

However, it should be recognised that there is a degree of "pre-contracting" that needs to take place in order for the PEC to be fully effective at enhancing GB's security of supply. It is no use suddenly thinking that Belgian DM loads can be interrupted and volumes supplied to the UK market in the event of an emergency. Arrangements and contracts need to be put in place beforehand. Whilst it might prove difficult to get storage volumes from continental Europe due to Public Service Obligations, the large end users who are able to either use back up fuel sources or are willing to commercially interrupt part of their load should be willing to contract for gas that can help avert a GB GDE.

Operating Margins

The 2011/12 tender for Operating Margins demonstrated that there was insufficient gas deliverability offered to the market to cover NGG's "Supply loss" requirements. This is a worrying development but perhaps is an area that needs to be more fully explored. More importantly, it is another potential area where sources of physical gas supply can be provided to avoid the GB market entering a GDE.

Testing of Winter Peak

Since the criteria for a supplier to meet its 1:20 peak demand has been removed and bookings and use of storage is primarily based upon the Summer / Winter spread, there is a real risk that suppliers are relying on "the market" to provide the necessary peak supply cover. This is because it is viewed as uneconomic for them to cover their requirements themselves and is perhaps at the heart of the current government concern.

We understand that Ofgem requests information from suppliers / shippers on how they are intending to meet their peak demand requirements. We would encourage this to continue and become a mandatory obligation for responses by mid September each year. This gives Ofgem the ability to analyse the full data set to identify the supply gap and ask those shippers who are under-providing how their shortfall will be met. It is not clear what the appropriate sanctions would be for either failing to provide the information, provide false or misleading information or failing to act on closing the gap.

Stockholding obligations

In order to improve GB security of supply, we believe that Ofgem should explore the imposition of a collective minimum stockholding obligation. This is not the same as a government or NGG-held strategic stock. It is simply a benchmark on [31st October] each year that requires GB suppliers / shippers to have in place a flexible, scalable stockholding.

It should be flexible in the sense that it can be storage in UK or adjacent countries and in either liquid or gaseous form. It should be scalable in the sense of increasing to reflect supply / demand conditions over time and to the extent that all customers or only priority consumers should be protected with a guaranteed supply.

This minimum stockholding can be achieved through the existing infrastructure, or would provide the incentive for new storage capacity to be built. This would have the additional benefit of providing further backup against the growing intermittency from the power sector. There would be no restriction on how suppliers used that stock during the winter but it is in place at the start of a winter to ensure that a GDE be avoided. We believe that there should be further discussion within the industry on this potential other measure because it will provide the physical security in terms of both stock and deliverability to avoid a GDE.

We trust that you find this a constructive approach in spite of our rejection of the SCR proposal as drafted. We believe that it is important to get this right first time rather than putting in place a two-part solution that is likely to be sub-optimal for consumers and the market.

If you would like clarification on any of the points raised in this response, please do not hesitate to get in touch.

Yours sincerely,

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BG GROUP

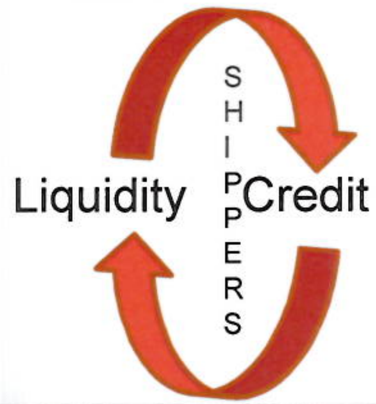
Security of Supply – creating the safety net

2011 work

SCR Cashout proposals

Fail to resolve GDE

Creates market disfunction



2012 work

Develop holistic view of risks and solutions to GB Security of Supply

Industry support and confidence that GDE is prevented
Least cost solutions chosen and targeted at firm demand

Annual Demand Side Reduction Auction

- NGG managed so they take off load where required
- Partial load shed at economic cost to DM consumers
- Ofgem need to burst the £20/th bubble that has raised expectations

Increase Operating Margins provision

Post Emergency Claim process
Encourage more pre-contracting with Continent al EU (BE / NE / FR) users

"Winter peak" test for suppliers

Stock Holding Obligation

- Set target for 31/10
- Progressive increase year on year from 4.5bcm now to 7bcm
- Removes seasonal disincentive to hold insufficient stock
- Market principles still maintained on use

SCR fails to provide the necessary solution to prevent GDE, yet harms market