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Subject: Detailed comments to Gas Security of Supply Significant Code Review (SCR) Draft Policy Decision

Dear Anna,

as agreed, further to the general comments I provided you with last Tuesday please find below BP detailed remarks to the SCR Draft Policy Decision questions which Ofgem proposed.

CHAPTER 3: Level of security of supply

Question 1: Are there any options for determining the level of gas supply security to be delivered by the market that we have not considered?

Question 2: Do you agree with our approach to setting the level of security of supply?

The effect of using a VOLL calculated for domestic customers on Firm Daily Metered customers effectively extends the same supply security standard for "priority customers" to all customers. The effect is therefore to impose a much higher security obligation and investment requirement. As has been stated many times in previous debate, this insurance product for higher levels of compensation will ultimately be borne by the customers themselves. We are sceptical that the evidence suggests that Firm DM customers wish to "over-insure" for higher compensation than their own VOLL suggests, and will be prepared to pay for this over-insurance.

Whilst Ofgem is entitled to apply a stricter interpretation of the European security standard subject to a number of conditions it appears strange that Ofgem is looking to compensate DM customers at the same level as NDM customers (albeit for the first day of interruption).

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It is likely that DM customers have a lower VOLL than residential customers who are considered to be ‘super firm’, i.e. should be interrupted last, in part, to the cost of reconnection following large scale domestic interruption. This is shown by existing storage monitors protecting domestic customers.

We do not accept the argument for setting just one VOLL on the basis that it is difficult to identify specific customers. It should be fairly easy to indentify DM disconnected load and hence a VOLL more specific to the DM sector should be applied.

CHAPTER 4: Cash-out reform

Question 1: Do you agree that it is appropriate to retain the Post Emergency Claims (PEC) arrangements? If not please explain why.

Yes we believe it is appropriate to retain the PEC arrangements. However, some amendments could be made to the arrangements.

NG should put in place a facility to anticipate or guarantee PEC to reduce insolvency risks and the burden from delayed repayments to long shippers. A solution could be to speed up PEC repayment, by completing the invoice process more quickly. Another measure could include NG estimating, at M+15, the likely portion of payments which it will have to recover from short shippers (we understand from NG the accuracy of this estimate is likely to be high).

We appreciate the above suggestions have a number of drawbacks. Firstly, we see a trade off between anticipating PEC repayments and collecting these, and delaying or spreading collection of VOLL imbalance charges from short shippers. This implies that any benefit to long shippers/customers causes an increase of credit costs for short shippers. Secondly, there is a risk that the Emergency Fund could be insufficient to repay both PEC claims and DSR. Any priority in the use of the fund would affect the other recipient. NG is in our view best placed to address these gaps and act as a cushion in a cost effective way.

We consider such enhancement necessary as we expect current PEC arrangements could possibly be inadequate in light of the high financial exposure which we expect from VOLL.

It is likely that shippers would be more able to supply gas during emergencies, knowing that repayments would be prioritized (assuming that gas is supplied at a much higher cost).

Question 2: Do you agree with how we have estimated Value of Lost Load (VoLL) and the level of VoLL that we have used? Is there a case for using a higher VoLL to incentivise more discovery of the demand side?

It should be remembered that an emergency may arise in the short, medium or long term. In addition, the nature of the emergency may be local, regional or global. Therefore, the effectiveness of VOLL to attract supplies in these circumstances may be significantly different.

During a local emergency that evolves slowly, higher prices will attract more supplies. Once the marginal price of the most expensive source of supply is exceeded it is unlikely that additional supplies can be attracted (storage of course has an opportunity cost associated with it but as the emergency progresses we would expect full storage withdrawal). This marginal cost figure is likely to be significantly lower than the suggested level of VOLL.

A global or even regional emergency which arises very quickly may limit the scope of GB shippers to attract supplies into the country at any price. A bidding war may then develop where countries seek to attract supplies. In this circumstance, it is likely that political pressure will come to bear on incumbent suppliers to maximise supplies to the home market rather than flowing to other markets. In these circumstances relying on public appeals is likely to be more effective than a very high VOLL. As an aside, if customers know they will receive VOLL as compensation should they lose supply they may little incentive to respond to any appeal (obviously the situation is likely to be different in summer than winter).

More generally, we disagree with Ofgem's premise that a high VOLL may result in physical investment by market participants to manage the risk of an emergency. Investments are justified by an expectation of a general rise in price levels or differentials sustained over a reasonable period. In fact, outliers are often weighted down when considering investment decisions as they can appear to be a "bet" that the rare event occurs.

It is also likely that the price of gas offered into the market or to NG will very quickly increase to VOLL, particularly where there is any uncertainty over supplies of gas, i.e. if a shipper cannot guarantee flow of gas it will seek to sell this gas at VOLL and will therefore be able to pay any shortfall which will be charged at VOLL. The evidence for this can be taken from the early days of the network code when parties with uncertain flexibility would attempt to capture the system marginal price. At this level, they would be paid the SMP for any gas accepted and delivered; for any underdelivery they would be paid and penalised at the same price (paid the offer price which ideally would be equal to the SMP, then cashed out for the shortfall at SMP). If there was expectation of a GDE, all gas would therefore be likely to be offered on OCM at VOLL and prices in the market would therefore rapidly escalate towards this level.

A further effect that could be expected is that where there is uncertainty over gas deliveries, this will reduce the willingness of producers to sell forward. Indeed it is more likely that quantities of gas will be held back until there is greater certainty over the quantities of gas available (this may especially be the case for associated gas), and there is a clearer idea on whether a GDE will be called, which will determine the value of the gas. Producers may also be more inclined to hold back production as "insurance" against shortfalls in their own portfolio. The unintended effect of an egregious penalty may therefore be that it actually reduces supplies available to the market.

As we advised in the initial consultation response, we have many concerns regarding the methodology and the level of VOLL.

Firstly, BP considers the level of VOLL is arbitrarily high and possibly not credible or realistic. We support the employment of economic valuation techniques, but we disagree with the extent to which Ofgem has interpreted such insight to infer conclusions about real gas prices. There are strong mismatches between the results of non-market valuation techniques and the real willingness to pay. The reaction of industrial customers to interruptions that occurred on January 7th 2010 (shock at being interrupted), showed how limited a customers understanding of the value of supply security when relating to such low-probability events.

Secondly, as noted above, selecting a single VOLL value across all categories of consumers and times of the year contradicts the variation which occurs across these dimensions. We understand that the structure of the current gas infrastructure limits the possibility to prioritize customer disconnection according to their individual VOLL value, but we disagree with Ofgem that the resulting logic is to enforce a single value. We at minimum expected Ofgem to select an average level of VOLL.

Question 3: Is one day domestic VoLL an appropriate administrative price for any firm load interruptions?

VOLL is likely to be different for every customer and will change at different points in time so we appreciate the attractiveness of setting a single VOLL figure. However, we disagree that the domestic VOLL calculation is appropriate for any firm load interruption. As noted above, it should be possible to indentify DM interruptions, and believe these interruptions should be compensated at an appropriate VOLL figures for this class of customer.

Question 4: Do you agree that it is appropriate to retain the Emergency Curtailment Quantity (ECQ) arrangements? If not please explain why.

We agree that ECQ arrangements should remain in place.

Question 5: To what extent do our proposals alleviate shipper's concerns about credit implications of targeting the full cost of multiple days of interruption on shippers that were short on day one of a stage 3 (network isolation) interruption?

Ofgem proposals provide some comfort supporting credit concerns. It is an improvement compared to the previous position where shippers would be liable for an unknowable exposure which would have been impossible to hedge against.

Question 6: Should extended payment terms be applied to emergency cash-out (possibly to align with payments through the PEC payment process)?

Extension of payment terms could avoid shippers going bankrupt or through financial hardship and ensure that large credit requirements are not needed. However, as discussed in Question 4.1., we see a trade off between extension of payment terms for short shippers and payments to long shippers and customers. We think that NG could overcome this trade-off through bridge credit lines (provisions for which could be made through the price control process).

Question 7: Will enhanced incentives to avoid an interruption occurring increase the number of interruptible contracts entered into by industrial consumers? Please explain why.

It is possible that shippers may seek to enter into a greater number of interruptible contracts with I&C customers to manage their exposure to the new arrangements. It should be noted that this is likely to result in higher costs as shippers compete for I&C customers which will be passed onto customers. There does appear to be a lack of appetite for interruptible contracts shown in recent auctions which signals that the value of firmness is possibly higher than expected.

There are alternative measures to meet the additional exposure under the new arrangements, including physical investment (although as noted above we believe this is unlikely), provision of additional credit and entering into contracts with market participants. However, it should be noted that this will increase incentives on upstream producers to declare and defend claims of force majeure (due to an offshore asset going offline for instance) which would expose the downstream shipper to VOLL on the short volume. This may reduce trading at the NBP and push higher proportions of trading back to the beach.

Question 8: Do you agree with our broad proposal for collecting monies from shippers and passing this through to customers? If not so you have an alternative proposal?

BP has no comments on this question.

CHAPTER 5: Possible further interventions

Question 1: Do you agree with our assessment that a gap in the emergency arrangements would remain following the introduction of capped cash-out? If

so, to what extent do you believe that this gap can be overcome through further interventions?

Question 2: Have we captured the full set of potential further interventions? If not what other further interventions should be considered?

We disagree about the existence of a structural gap in GB emergency arrangements. The GB market has seen unprecedented levels of investment over the past several years, largely due to the liberalised nature of the market. Conversely we believe that there is room for incremental improvements in the consistency of GB market design. We consider that further interventions could address three areas:

- consistency of overall emergency market arrangements
- improvements of administrative process for investments in flexibility
- harmonization of emergency arrangements across EU neighbour countries.

In addition, we see VOLL emergency arrangements could have the potential to worsen existing arrangements. As discussed above in question 4.1, the cash-out penalizes heavily short shippers but is asymmetrical in the incentives it provides to long shippers to supply more gas.

The consistency of emergency arrangements could be improved with incremental arrangements to existing market design. Recent cases of tight supply showed that most constraints in the GB market have been related to limitation in the transportation network capacity and reliability. We consider these arrangements would much more effectively advance Ofgem goal to reduce the likeliness, and would certainly provide much greater cost benefit effectiveness.

More generally, we believe that any measures, whether long or short term, should take into consideration the nature of the emergency. For instance, is it a local emergency, where shippers have some degree of control over supplies, whilst for a more global emergency control over supplies is far more limited.

CHAPTER 6: Assessment of options

Question 1: Do you believe that we have captured all the appropriate options?

Question 2: Do you agree with our assessment of the costs and benefits of the various options?

Question 3: Do you agree with our preferred option?

We do not agree with the tacit assumption that the level of gas attracted into the GB system will be higher the higher VOLL is set. This assumption overestimates the degree of flexibility that shippers have to increase gas supplies in response to higher prices in all circumstances and as we note physical investment projects are unlikely to result from the proposed changes.

As discussed below, we would have appreciated Ofgem considering simultaneously network enhancements which put shippers in a position to better accommodate significant changes in demand volume and origin and which increases the overall capacity of the network. These constrains are in our experience the biggest problems we experienced in the latest GBA.

In addition, Ofgem should be considering changes to cash out as part of the medium term security of supply work and further interventions work in the round. It is possible that the proposed changes to the cash arrangements may be incompatible with subsequent proposals for further interventions resulting in the reopening of gas emergency cash out.

Finally, the current option has a mismatch between the range of events which generate an emergency and a VOLL repayment and the kind of risks which are under shipper control. We express concern about the lack of any force majeure event which caps shipper exposure to risks.

APPENDIX 3: Further interventions

Question 1: Do you have a preference for a specific intervention/s that you think might be most effective for ensuring security of supply while minimising the risks and unintended consequences?

BP believes the current market arrangements have been successful in finding efficient and effective solutions for supply security. As noted above we doubt that VOLL arrangements are likely to trigger physical investment.

We believe the most effective incremental change to the gas market to bring new investment would be to ease authorization procedure for new infrastructure. Recent experience showed that network constrains have been so far the greatest limit to the amount of gas which can flow into the network.

Another intervention which we consider much more useful is to enhance cooperation with neighbour countries. The disparity between security measures across the EU could increase uncertainty and during an emergency could trigger an escalation of prices which would harm both the GB market and the continental ones. Pressure on other EU countries bilaterally and via the EU, to adopt pro competitive practises is likely to do more for security of supply than the proposed measures by Ofgem.

We were also very surprised at the lack of consideration of the GB electricity market. Given gas fired generation makes up a significant portion of gas consumption.

Positive developments that are likely to improve future security of supply in GB and more widely include greater gas/electricity interconnection, new storage build, increased low carbon generation, greater competition across Europe, smart meters and the current forecast for gas exceeding supply into the medium term. At the very least Ofgem should pause before they decide to interfere in a way that could crowd out private investment.

Question 2: Do you think that standard contracts combined with cash-out reform provide the necessary incentives for suppliers to increase penetration of contracts for interruption?

Question 3: A number of stakeholders have suggested an auction for interruption. We outline several challenges with such an approach and are keen to hear proposals on how to overcome these challenges.

Recent evidence points at a much lower interest for the provision of interruption services than expected. Our view is that the prospect of a customer receiving £ 20/th if interrupted could lead to customers being able to secure lower prices for interruptible contracts. If agreed, these reduced revenues would be likely to be funded through increased prices for firm contracts.

Question 4: If some kind of storage obligation was to be implemented, do you favour an obligation on suppliers or shippers? Alternatively, do you think

the system operator or government should invest in strategic storage or build storage facilities for the industry to use?

We do not support any form of strategic storage. We think that evidence from other EU countries point at the huge costs which such an approach generates. Signals from countries such as Italy, where this solution is being reconsidered, provides in our view a further indication of its lack of effectiveness.

Whilst we consider that the most effective solution should place an emphasis on market based elements and competition, if such an approach is to be adopted we consider tendering for capacity could be in this case the most effective solution.
Yours sincerely,

Please do not hesitate contacting me should you wish to discuss further the above points or if you have any question.

Yours Sincerely
Antonio Ciavolella
Regulatory Specialist