Consumer Focus
Campaigning for a fair deal

31st January 2012
Anna Barker
Ofgem
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Dear Anna,

Response to Gas Security of Supply Significant Code Review – Draft Policy Decision

We are pleased to have the opportunity to respond to this consultation.

We are broadly in agreement with the choice of option 4 as the preferred option for the SCR. We note that it is the most expensive option for consumers, but also that it is the option which is projected to make a gas outage, both for larger and smaller customers, very much less likely. The average cost per consumer of £6.66 seems reasonable, although we feel that it would be helpful to have a clearer sense of how this cost is made up.

We are somewhat concerned by the incentive arrangements in cases where the gas supply crisis is so severe that it leads to network isolation. We understand the reasons for which cash-out is limited at one day's VoLL in this case, and that the speed with which the gas network is re-connected is not, largely, within the control of the shippers. However, it seems somewhat odd that a situation could arise in which shippers would pay out less in 'compensation' if they precipitated a stage 3 crisis, as they would only be paying isolated areas for one day's VoLL, than if they were able to manage the crisis and keep it at stage 2 level, in which case they could be paying for load shedding for considerably longer. In addition, we feel that it may be appropriate for there to be some sort of incentive on distribution networks to reconnect as quickly as possible areas which have experienced network isolation.

In addition, we feel that more work could be done to identify the mechanism through which customers will be compensated in the event either of load shedding or network isolation, particularly in terms of how the compensation would reach.

We would also like some reassurance that work on gas security of supply is fully joined up with any work which is done on electricity security of supply. We are aware that the gas SCR increases electricity security in itself. However, since a considerable proportion of our electricity generation relies on gas, any gas supply issues may have an effect on electricity supply, at the same time as potentially increasing demand for electricity.

Please see the appendix for answers to specific questions. This response is non-confidential and may be displayed on your website. If you have any queries regarding its content please contact me on sophie.neuburg@consumerfocus.org.uk or 020 7799 8043

Yours faithfully,

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Appendix 1: Answers to specific questions

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?
Not that we are aware of.

Question 2: Do you agree with our approach to setting the level of security of supply?
Any approach must meet or exceed EU legislative requirements, so it seems sensible that Ofgem is using the gas security of supply regulation as a benchmark for judging whether an intervention is merited.

Any assessment conducted now is likely to become quickly outdated, as the UK gas market is rapidly changing. In the course of a few years we have moved from being a net exporter of gas to a net importer and the extent of our import dependence is likely to increase. The impact of shale gas on European markets remains unclear. The electrification of heat and the balance of our future electricity generation portfolio will also change gas demands. We therefore suggest it would be prudent to conduct a periodic (annual or biennial) assessment of the likelihood that the regulation will continue to be met, factoring in any changes to the gas market that have taken place since the last assessment. This assessment should be published in order to inform stakeholders and to allow for any assumptions to be understood and rigorously tested.

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.
We do not have a view on this.

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?
We understand that domestic VoLL is the highest VoLL which has been calculated, meaning that VoLL has been set at the highest value that society puts on it. We do not, therefore, think there is a case for using a higher VoLL.

Question 3: Is one day domestic VoLL an appropriate administrative price for any firm load interruptions?
We are interpreting this question to mean any firm load interruptions under network isolation, rather than any firm interruptions under stage 2.

We understand that cash-out in the event of a stage 3 crisis is capped at one day's VoLL because once the network has been isolated it is not within shippers' control to influence how quickly the gas network is brought back to normal service, and because given the length of time this might take, forcing shippers to pay VoLL for each day would increase the likelihood of their financial collapse.

However, we have a number of concerns with this arrangement. The first is that it could be considerably less financially damaging for shippers to reach a stage 3 crisis quickly, than to manage a crisis better and maintain it at a stage 2 level for a longer time. Although a shipper

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would be highly unlikely to precipitate a stage 3 crisis on purpose, it nonetheless seems problematic that the incentives are not more closely aligned to outcomes. We understand that further interventions may aim to partly deal with this. In addition, although the length of time for which consumers may be cut off is beyond shippers' control, so shippers should not be liable for the full cost of this, they would have precipitated the crisis which led to the isolation, so it could be argued that they should bear more of the cost than they do under the policy proposals.

The second concern is that under the proposed arrangement, there is no incentive for network operators to restore service as quickly as they can, in the way that there would be if the isolation had been through their own fault. In addition there is no mention of compensation for network operators for what would be an expensive and difficult job of stabilising the network and reconnecting it. We wonder, therefore, whether there might be a way in which operators could receive a payment for the work they must do to reconnect the networks, which would be weighted so as to incentivise them to reconnect consumers as quickly as possible.

The third concern is with the use of the word 'compensation' in this instance (we note that it has not been used in posing the question but it is used throughout the draft decision document). If a firm customer is interrupted as a result of a network isolation they may be without gas for weeks, or potentially months. In this context, one day domestic VoLL by no means amounts to compensation for this.

Question 4: Do you agree that it is appropriate to retain the Emergency Curtailment Quantity (ECQ) arrangements? If not please explain why.
We do not have a view on this.

Question 5: To what extent do our proposals alleviate shippers' 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?
We do not have a view on this.

Question 6: Should extended payment terms be applied to emergency cash-out (possibly to align with payments through the PEC payment process)?
We are comfortable with extended payment terms as long as there is an appropriate balance between granting shippers sufficient time to be able to pay cash-out and ensuring that consumers receive the funds in a timely manner. It must be borne in mind that consumers will be out of pocket until compensation is paid; over-extended payment terms may simply transfer financial distress from shippers to consumers. Given that consumers have far less control over the likelihood of a gas emergency emerging than shippers do, and that consumers are being asked to pay additional monies to insure against that risk, such a transfer of financial distress would not be appropriate. We would suggest that further consultation is carried out with business customers to confirm that extended terms would be appropriate.

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 depends on what is currently driving the reluctance of many industrial consumers to enter into interruptible contracts. If it is purely that they are not financially attractive enough then increased incentives may make a difference. If there are other factors at work, for example, that their industrial processes are incapable of easy interruption, then it may make no difference.

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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?
The broad proposals seem fine. We prefer the first option, at 4.42, over the second option at 4.43, as we do not see the necessity for an additional agent in the process, unless there is a danger that the cash-out charges fund would not be managed properly unless there were an additional agent.

We note that further thought is needed on how monies will be passed to customers once they have been collected. The Impact Assessment suggests at 2.82 that for domestic customers this may come as a rebate on a gas bill; there is no mention of a different method for large or small business customers. We would argue that a rebate on a gas bill may be unsatisfactory to some business customers, as depending on how often they are billed, it may mean a long wait before they receive the benefit of the extra funds. The same holds true for domestic customers who, if they are vulnerable, may find themselves in financial difficulties as a result of using electricity to heat homes over a period of time and may need the involuntary DSR payment sooner than their next gas bill.

We would suggest that many customers would rather receive a payment than a rebate on a gas bill, and that there should be an explicit cap on the time that it takes for this payment to be made. We would also suggest that Ofgem consider the possibility of interest being levied on monies due to be paid by shippers to customers as an incentive for speedy payment.

We were perplexed by the comment in the Draft Impact Assessment at 2.37 that payments for involuntary DSR can mitigate risks that customers face, particularly vulnerable customers who may not be able to afford to make other arrangements. As is noted elsewhere in the Impact Assessment and the draft decision, these payments will not be immediate and will therefore not shield vulnerable customers, or indeed some businesses, from the immediate effects of a lack of gas.

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?
We do agree that a gap in the emergency arrangements would remain, and that therefore further interventions may be necessary. It is not clear from the consultation document which of the further interventions Ofgem favours for option 4, although we can see that a storage obligation has been used for the purposes of modelling.
For details of our view on further interventions please see answers to questions on Appendix 3.

Question 2: Have we captured the full set of potential further interventions? If not what other further interventions should be considered?
We would suggest a further intervention of some sort of financial incentive on network operators to reconnect networks as quickly as possible in the event of an isolation. We recognise that in this context network isolation is not the fault of the network operators but in the interests of minimising the damage done to large and small consumers it seems appropriate to take steps to ensure that reconnection can take place as quickly as possible. We also recognise that dealing with a network isolation could prove very expensive for network operators, and wonder whether some of the cost of this could be met by the shippers which caused the supply crisis.

CHAPTER 6: Assessment of options

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

Question 2: Do you agree with our assessment of the costs and benefits of the various options?
On the whole, yes. However it is a little difficult to take a view on the costs and benefits of options 3 and 4. The cost/benefit modelling which has been done for these options assumes that the further intervention undertaken is storage obligations on suppliers, whereas the policy document mentions a number of other potential interventions. It is unclear how the assessment of the costs and benefits of options including further interventions could be complete without modelling which includes all of the potential interventions that are being proposed.

Question 3: Do you agree with our assessment on a preferred option?
Again yes, on the whole. We understand that Option 4 is the most expensive for consumers, but that it will, according to the modelling, make a gas supply emergency least likely. However, as mentioned above, in order to come to a firm conclusion over which option we would prefer, we would need further information on the costs and benefits of other 'further interventions' which are mentioned in the draft decision.

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?
We do not at present have a preference for a specific intervention; it might be easier to develop a preference if the cost/benefit analysis were done for the interventions suggested other than storage.

Consumer Focus is not generally supportive of additional gas storage as we do not believe that it provides value for money at this point. However, as stated above, we do feel that Option 4, at its modelled cost including storage, and with its modelled probability of firm NDM interruptions, provides reasonable value for money.

We are not clear that information obligations would necessarily improve security of supply. This is because, as the document notes, contractual information changes rapidly and while a shipper may have sufficient supply to meet demand at a certain point when they are reporting, this could change immediately after the reporting date. If this intervention were to be put in place we would favour reporting on an ongoing basis, rather than reporting at longer intervals throughout the winter or throughout the year.

We find the each of the options for a licence condition as a further intervention somewhat puzzling. A licence condition which requires suppliers to prove that they can meet demand seems very similar to the information obligation discussed above, and may have similar pitfalls. A licence condition specifying that suppliers do in fact meet demand may be counterproductive in the same way that Ofgem has stated that uncapped cashout may be counterproductive. If there were a gas supply emergency and suppliers/shippers were unable to meet demand, as well as paying out VoLL at the relevant rates, suppliers would also stand to be fined 10% of their global turnover. This could increase liabilities (albeit proportionately to size), increasing barriers to entry to the market, and, in a situation where shippers were already paying out for involuntary DSR services, may not in fact be credible.

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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?
Please see answer to question 7, chapter 4, above.

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.
We do not have a view on this.

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?
Given the costs associated with investing in storage facilities, we would very much favour investment by government as this would be more socially equitable, coming out of taxation, which is progressive, rather than consumer bills, which would be regressive.

If government were not to pay, we have no view as to whether the obligation should be on suppliers or on shippers since in many cases they are separate branches of the same companies.

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