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Dear Anna,

RE: Draft Policy Decision - Gas Security of Supply Significant Code Review

E.ON is unconvinced that the Ofgem proposals under this Significant Code Review (SCR) will deliver material improvements in GB security of supply. Furthermore, we do not believe that Ofgem has demonstrated the need for further intervention, in addition to the proposed cashout reform, as proposed in this initial decision consultation.

As we have stated previously, Shippers already face multiple, strong incentives to manage their imbalance risks, particularly in respect of avoiding a Gas Deficit Emergency (GDE). Furthermore, as set out in our initial written response, we believe that the market can be relied upon to deliver effective security of supply measures, as evidenced by the market's well-proven track record of delivering even under extremely tight and challenging circumstances. Indeed, this was DECC's conclusion in November 2011[1]:

"Security of gas supply in the UK is provided through effective gas market arrangements with sharp commercial incentives on shippers to supply their customers. The UK already carries out significant risk assessment" and that *"The UK gas supply infrastructure is resilient to all but the most unlikely combinations of supply shocks. Supplies to protected consumers (including households) are maintained in all scenarios*."

[1] DECC: "*Risk assessment for the purpose of EU Regulation 994/2010 on security of gas supply*", November 2011.

Given that the only concerns are around "*unlikely combinations of supply shocks*", we do not believe there is a case for such significant changes to the cashout arrangements and the introduction of customer 'compensation', as proposed by Ofgem. These highly complex proposals have the potential to complicate the safe and efficient resolution of an emergency situation or precipitate Shipper failure through extremely harsh commercial penalties. Moreover, we believe the ability of Shippers to react in an emergency has been overlooked. As noted in our initial response, a cashout-driven price arbitrage in favour of the GB market will only deliver results if / when there is physical gas available for delivery in or to GB. Once the supplies have dried up, further price increases will have no impact in terms of improving security of supply.

We believe a more pragmatic and proportionate solution, with the potential to minimise the identified outlying risks, would be for the industry to look to contract for increased demand and supply side response through a National Grid coordinated tender (or auction). If designed appropriately, such a mechanism could deliver enhanced certainty for the GB emergency arrangements without distorting the existing wholesale market. We believe the design of such a tender could be as follows:

- Based on (or an extension to) the existing National Grid NTS Operating Margins (OM) tender.
- Demand side able to bid-in: Gas fired generation plant, large I&C load.
- Supply side also able to bid in: Gas storage space / deliverability.
- Demand reduction / supply increase must be measureable to be accepted – i.e. metered.
- Direct contracting between provider and National Grid NTS (as per OM arrangements).
- Bidders free to structure own contract – e.g. option & exercise or exercise only.
- Annual tender, but National Grid NTS could accept single year or multi-year contracts.
- Costs shared amongst all Shippers, as per existing OM arrangements.
- Volume requirement determined by National Grid NTS – potentially by reference to European Security of Supply standards.
- Exercise of contract post-GBA and pre-Emergency.

Having known contracted volumes in advance would aid National Grid NTS in adopting an orderly approach to interruptions, particularly in respect of minimising the effects of the "*unlikely combination of supply shocks*" scenario outlined by DECC. As a result, the likelihood of an emergency materialising may be reduced, should such a tender be introduced.

The tender would also address the issue of firm customers not being eligible for compensation in the event of supply interruption, since those who participate in the tender would receive payment if accepted by National Grid NTS. An additional security of supply benefit is that sufficient 'option' payments may lead to more back-up supplies being installed (or at least existing facilities not being decommissioned) if the payment is at a level and duration which could commercially justify this – e.g. over a 5 or 10 year period.

We acknowledge that this particular proposal is not without its complications and would likely require changes to NG's licence (e.g. to allow customers to contract directly with a Transporter); however, given that we are approaching a new price control period, it would seem the most opportune time to consider these important issues.

We urge Ofgem to focus on developing the proposal outlined above, rather than concentrating on its proposed and potentially unworkable cashout reforms.

The Governance Process

Whilst Ofgem has considered many of the issues in detail, we believe that too much time in the SCR workgroups has been spent developing Ofgem's preferred way forward, rather than developing an industry consensus-based way forward. We do not believe there is any lack of will on behalf of the industry to help improve the current emergency arrangements, but we consider that Ofgem's proposed way forward could be adapted to better represent the industry consensus. We are also conscious of an already highly challenging investment climate, which may be worsened through unduly interventionist measures.

<u>Specific Consultation Questions</u>

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?

We believe that the market is best placed to deliver security of supply through a diverse range of infrastructure and products. As DECC notes in its recent publication "*Risk assessment for the purpose of EU Regulation 994/2010 on security of gas supply*" (November 2011):

"The market has delivered a 500% increase in the UK's gas import capacity during the last decade (150% of annual consumption) and a 30% increase in storage capacity, since around 2000. It responded well in the winters of 2009/2010 and 2010/11 to meet record demands and supply side pressures".

It is critical to this continued success story that the already challenging investment climate is not materially worsened by market arrangements which could make it uneconomic or unattractive to invest in GB.

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

No. Using VoLL (in combination with the Redpoint analysis) as a proxy for a level of security of supply is not credible in our view, since it does not relate to the physical network. GB is now subject to European requirements in respect of gas security of supply, which DECC has concluded that GB is compliant with. In DECC's Statutory Security of Supply Report 2011 (published 8 November 2011), it is concluded that:

"(GB) has an increasingly large and diverse range of import sources on which to draw..." and that "...*in recent years the gas market has delivered substantial investment in new supply infrastructure and there have been no firm customer interruptions*".

We are therefore unsure what additional level of security of supply is required (in the absence of a higher, defined standard) and whether there is a willingness of customers to pay a premium for such a higher standard. Moreover, it is impossible know what the market should be aiming at (or where it is perceived to be deficient) in the absence of a defined security of supply standard specifically for GB. If DECC and Ofgem are insistent that gas security of supply must be increased, it will be necessary for them to define exactly the security standard required.

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.

On balance, we believe it is probably appropriate to retain these arrangements regardless of whether Ofgem's SCR proposals are implemented, since the process may encourage additional (albeit in all likelihood, marginal) sources of supply to GB in an emergency.

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?

No. We do not support the use of the concept of VoLL in the GB emergency arrangements. Ofgem's proposed level of £20/thm is likely to act as little more than an artificially high target price in respect of cashout prices and customer interruption payments, which would unduly distort the market, particularly in the run up to a possible GDE.

As outlined above, we believe that a demand and supply-side tender would provide the opportunity for ‘compensation’ to be set at a price proposed by the provider – in other words, effectively allowing them to express the value they place on providing demand or supply side flexibility services to the system – which is, as far as we understand it, one of Ofgem’s key objectives behind its ‘VoLL’ concept.

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

No. For instance, a generator or large I&C customer would place a very different price on either reducing load or being interrupted than a domestic customer and it is not credible to apply the same value to any connected gas consumer in GB. To do so is to over-simplify the value that customers place on a firm gas supply. The alternative would be to create VoLL values for every single customer, which is clearly impractical and vastly over-complicating the emergency arrangements. In any case, once a GDE at Stage 2 is declared, the NEC will take control of firm load shedding with no consideration for commercial values: All decisions are taken on a physical basis. Therefore, VoLL would have no direct role in influencing the outcome of an emergency.

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

No, if Ofgem’s proposed cashout reform solution is implemented, retaining the ECQ adjustment mechanism would be doubling-up penalties on Shippers. The ECQ mechanism acts as a significant incentive on Shippers already to interrupt their own customers in a GDE, since failure to do so sees Shippers penalised by having their balancing position adjusted. Having an additional penalty on top of a highly penal cashout price would be adding more financial pain to the situation and will only exacerbate the positions of Shippers already in financial distress due to the emergency situation.

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

Whilst Ofgem’s revised proposals are less extreme than the initial proposals (i.e. targeting the full cost of multiple days of interruption on shippers that were short on day one of a stage

3 GDE), we still have major reservations about parties' credit facilities being able to match the potential financial liabilities in an emergency. If the market arrangements could create a situation of financial distress so extreme that no Shipper could reasonably cope, the arrangements will lack all credibility, and if anything could result in a GDE becoming *more* likely if parties assume that in an emergency the commercial arrangements will simply fall apart and that liabilities would not be enforced.

Ofgem's assumption seems to be that Shippers would have access to credit facilities extending their current credit position far beyond current levels; which would be necessary in the event of a £20/thm cashout price applying to short shippers. Whilst this might, in theory be possible, it would come at a large cost to the whole Shipper community (and ultimately consumers), since existing credit requirements could have to be increased perhaps by a multiple of 5 or 6 times current levels to account for the possibility of a GDE and the associated potential liabilities. Work by the UNC Energy Balancing Credit Committee (EBCC) has shown that the cost of obtaining Letters of Credit (LoC) has increased in recent years and even for a Shipper with a 'good' credit rating, the cost could be in the region of 1 - 10% of the value of the Letter of Credit. For those without access to LoCs, the burden will fall in the form of increased requirements for cash to be posted to cover their credit position, thereby reducing working capital.

In addition, we have strong concerns about the high amount of off-line and manual adjustments that xoserve (on behalf of National Grid NTS) would have to perform during an emergency. For instance, an incorrect manual adjustment could lead to premature termination of Shippers under the UNC.

In an emergency, the most important thing we should be striving for as an industry, above all else, is clarity of roles of all efforts focused on the quick and safe resolution of the emergency. The current frozen cashout price assists in this regard as it provides some degree of certainty in a potentially confusing and highly dynamic environment. Introducing additional layers of complexity, leaving some Shippers uncertain of their financial position is not, in our view, going to assist with the restoration 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.

We do not believe that Ofgem's proposals, if implemented, will lead to a significant number of interruptible contracts being signed. During 2005, when supplies were tight and the likelihood of a gas emergency was higher than it is today, E.ON with a series or road shows and targeted marketing sought to agree such demand-side contracts with its customers including emergency curtailment contracts triggered by a GBA. Despite our best efforts, we were only able to agree a handful of contracts and that was against a back-drop of an incentive on customers to agree to be interrupted ahead of an emergency for a large cash payment or get nothing if curtailed in an emergency. How much more difficult would it be to enter into such agreements in a world in which customers receive a very large compensation payment in any event (i.e. £20/thm VoLL).

Ofgem's proposal to introduce VoLL at £20/thm significantly complicates and reduces the likelihood of customers signing interruptible contracts. Having a guaranteed compensation value (if they effectively "do nothing") removes any incentive on large I&C customers to engage in negotiations for a commercial interruption contract at a level lower than £20/thm. Currently, large I&C firm customers face the potential 'dilemma' of agreeing an interruptible contract and receiving compensation or remaining firm and not receiving any compensation in the event they are interrupted. Under Ofgem's proposed reforms, the options facing customers would be to agree an interruptible contract with its Shippers, or stay as a firm supply point and be guaranteed an even larger sum (£20/thm) if they are disconnected. As a result, the incentive to contract is reduced compared to the current arrangements.

A more practical model would be to introduce a demand and supply side tender, which in our view is far more likely to result in more contracted demand and supply side response.

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?

We are concerned that Ofgem's proposals have the potential to leave a very large hole in the neutrality 'pot', since funds from short shippers, which would ordinarily go towards paying long shippers and for market balancing actions, will instead be diverted out of neutrality and into funding the customer compensation payments. There is therefore, a hole in neutrality, which apparently would need to be filled by short shippers (doubling up the proposed penalties) or by the generality of Shippers (thereby, socialising the costs of the emergency across all Shippers, regardless of their own balancing position). Ofgem's proposals lack sufficient detail to explain the consequences and attribution of liabilities in the event of a deficit in the neutrality 'pot'.

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 believe there may be scope for incremental, market-based change; such as through the introduction of a demand and supply side tender, but we disagree that there is a 'gap' that requires intervention; particularly in the current absence of a defined GB gas security of supply standard.

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

The document covers a wide range of possible interventions and at a high level captures the main advantages and disadvantages; but lacks the necessary detailed review of each. However, we would reiterate that we do not believe the case has been made for further interventions, regardless of whether or not cashout reform is implemented. We are not aware of any market failure in respect of GB gas security of supply which would justify pursuing this option and unless a higher security of supply standard is defined by government, we are unsure where the perceived 'gap' exists.

In addition, we would like to make it clear that we do not see a demand and supply side tender as a fundamental change in market design given it is conceptually similar to the current OM tender process and it would not distort the normal energy market, given contracts would only ever be exercised by NG if there was an immediate threat of an emergency. The tender could be designed to complement the existing market rules and be completely market-based. Moreover, it is likely to be much less interventionist that Ofgem's cashout proposals which effectively introduce a regulated cashout price and regulated customer 'compensation' level.

CHAPTER 6: Assessment of options
Question 1: Do you believe we have captured all the appropriate options?

As outlined in our previous response, we noted that there could be scope in the current emergency arrangements for incremental improvement by introduction of different rules for different types of emergency (i.e. 'slow' vs. 'rapid' emergency), since this could ensure the arrangements better reflect the ability of market participants to react to an emergency. It is disappointing that Ofgem has dismissed this option, despite support for developing it further from other market participants, including the Gas Forum. On this basis, we do not believe that Ofgem has properly considered all the market-based reform options open to it.

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

Whilst the assessment of costs and benefits has clearly been extensive, there are also many assumptions made within the Redpoint modelling of which parties may legitimately question the validity. For instance, the quoted 1-in-16 likelihood of Firm DM interruption figure suggests a relatively high risk of interruption, which is not consistent with the general industry view and to date there have been no *firm* customer interruptions historically that we aware of. Therefore, we believe Ofgem should be careful not to place undue emphasis on the initial modelling, which in our view merits being revisited following industry comments received through this consultation and the workgroups to date.

Question 3: Do you agree with our assessment on a preferred option?

Ofgem's conclusion that "a further intervention" in addition to its proposed cashout reform is required is unhelpful, since it does not actually specify *what* intervention. We are therefore uncertain of what exactly is being proposed and as a result it impossible for us to understand and quantify the full effect on our business.

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 must reiterate that in our view, the GB wholesale gas market has proven over time to have delivered effective security of supply and that we do not see a case for intervention. This is backed up by DECC's most recent assessment of the GB wholesale gas market, as referenced earlier in our response.

A key risk of any market intervention is the increased perceived regulatory risk that this may bring, which may undermine future investments in the UK. Ofgem should be mindful of impacts, particularly in respect of worsening the investment climate or reducing liquidity at the NBP if it is considering implementing a market intervention measure.

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?

A standard contract template could be helpful in achieving greater level of contracting for interruption with customers, but in our view, Ofgem's cashout and customer compensation proposals, particularly VoLL at £20/thm, significantly reduce the likelihood of interruptible contracts being signed for the reasons outlined earlier in our response.

It should also be recognised by Ofgem that the majority of customers want and expect a physically firm gas supply and do not wish to move to interruptible status. This point has been made repeatedly through the development workgroups by both Shippers and I&C

customer representatives. Moreover, we understand that many of those customers that were interruptible, pre-UNC Mod 90 and Exit reform and who previously had back-up fuel facilities to allow them to be physically interruptible, are currently removing such back-up facilities. This will increasingly leave a smaller pool of potential interruptible customers to contract with, regardless of any VoLL-based incentives.

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.

Our proposed design for such an auction (or tender), which should also include supply side response, is outlined at the beginning of our response. We believe this option would be best developed in a focused workgroup as part of the overall SCR process.

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?

E.ON UK does not believe that a gas storage obligation of any kind would improve the current GB gas market arrangements.

Conclusion

In recent years, there has been significant investment in diverse physical assets to increase import capability and flexibility of supplies to GB. We concur with DECC’s assessment that the GB market is well supplied and resilient and this has been demonstrated over recent cold winters. Whilst we do not disagree with Ofgem’s assessment that there is room for improvement, we believe reform in this area must be incremental, proportionate to the risk and market-based to ensure that the GB success story is continued in the future. We do not believe that Ofgem’s proposals under this SCR (and its proposal to intervene in the market) meet these criteria. We are concerned that the lack of market-basis to the proposals has the potential to undermine future investments and harm liquidity in the GB wholesale gas market.

We urge Ofgem to instead pursue the development of a more market-based approach in the form of a demand and supply side tender. Such a tender has the capability to measurably increase contracted demand reduction or supply increases and in doing so, reinforce the level of gas security of supply in GB.

I hope that the above comments prove useful. Should you wish to discuss our response in any further detail, please do not hesitate to contact me on T: 02476 181421.

Yours sincerely,

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