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Dear Anna

Gas Security of Supply Significant Code Review - Draft Policy Decision

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, combined heat and power plants, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including both residential and business users.

EDF Energy welcomes the opportunity to respond to this consultation. Our key points are as follows:

- DECC's recent UK security of gas supply risk assessment states that the UK meets the EU Gas Regulation Security of Supply standards and is resilient in the short to medium term.
- Greater clarity is required on the security of gas supply problem that needs to be resolved and whether the UK needs a higher gas security of supply standard than the EU Gas Regulations. This would be consistent with DECC's approach to security of supply under Electricity Market Reform.
- A clear identification of the problem, when it is likely to occur, its size and the likelihood and frequency of occurrence, should ensure the most economic solution is developed.
- Redpoint's risk assessment shows that the current arrangements are robust and meet demand in all but one scenario, where firm industrial customers may be switched off once in every sixteen years.
- Any change should consider the interaction between the gas and electricity markets to ensure that there are no unintended consequences.
- We note the lack of Demand-Side Response and believe this is an area that may increase the UK's security of supply.
- There may be merit in unfreezing cash-out prices; however, there are specific areas that need to be resolved, such as credit implications to limit any unintended consequences from this reform.
- Very high cash-out prices may lack credibility and adversely affect the UK gas market and its level of supply security. A cap on cash-out prices may be needed to protect the market and consumers.

- Setting a value of loss load for domestic consumers is difficult and any figure put forward will be unreliable given the health and safety implications associated with network isolation.
- Smart metering may provide positive benefits in facilitating Demand-side Response and providing price discovery in the longer term.

In the attachments to this letter we discuss the above points and a number of further issues in more detail.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact my colleague Stefan Leedham on 020 3126 2312, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Denis Linford
Corporate Policy and Regulation Director

Attachment

Gas Security of Supply Significant Code Review - Draft Policy Decision

EDF Energy's response to your questions

Consultation 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?

The EU Gas Security of Supply Regulation 994/2010 determines the minimum standards that member states should meet. GB currently meets and surpasses this security of supply standard as reported by DECC in their November 2011 assessment.[1] We would welcome greater clarity and detail about the exact identification of any potential gas supply deficit which could:

- Cause the UK no longer meet the current standard at some point in the future; or
- Would imply that the UK needs a higher standard of security of gas supply.

If based on the detailed analysis required above Ofgem believe further standards are needed over and above that stipulated in the EU requirements and the high levels the UK has, then these should be made transparent and evaluated further with the industry and DECC under this review.

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

We agree that the EU Gas Security of Supply Regulation should set the minimum standard however any movement above and beyond this level needs to be justified and in line with the Gas Regulation requirements which state that any higher standard shall not:

- Unduly distort competition or hamper the functioning of the internal market in gas; or
- Impact negatively on the ability of any other Member State to supply its protected customers in accordance in the event of a national, Union or regional emergency.

[1] **http://www.decc.gov.uk/en/content/cms/meeting_energy/en_security/eu_sec_reg/eu_sec_reg.aspx**

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.

It would appear that the PEC arrangements will still be needed even in the event that cash-out prices are unfrozen in an emergency as there are always unintended consequences that will need resolving following an emergency. This will give parties greater comfort entering the market and following an emergency that there costs will be covered.

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?

The work done by London Economics to determine VoLL appears reasonable; however, it is difficult to say whether the ensuing value of £20/therm is the right level or not. This is an extremely high figure compared to historic prices seen during previous winters where some large consumers reduced their demand at prices in the region of £2 to £2.50/therm.

The evidence presented suggests that the market signals for balancing are clear. It would also appear that market participants and larger customers, who can stave off an emergency by offering their gas back to market, are clear on the risks and likelihood of interruption, especially given the tight winter of 2005/06 (see answer to Question 1 Chapter 5 below). However, we note that there may be a value in Ofgem communicating these risks clearly to ensure that this understanding is maintained.

It is therefore not clear that using a higher VoLL will incentivise more discovery of the cost of demand-side response.

Unfreezing cash-out prices may increasing the incentive on market participants to balance both prior and during an emergency; however, it is difficult to say whether introducing an artificial VoLL would be in the consumer's best interest as it may also create unintended consequences. In this case it is not possible to say whether these arrangements are being bound by introducing a cap of £20/therm as cash-out prices could equally be less in a real emergency.

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

The appropriateness of any VoLL will depend on what the security standard that Ofgem is trying to achieve.

The £20/therm VoLL was estimated using the Gas Regulation standard of a seven day outage that may occur once in every twenty years rather than for one day. It may therefore be seven times too high. We also note that Ofgem proposes it would apply

continuously for all days of firm load shedding where individual large consumers are required to reduce their gas demand.

The interaction between the gas and electricity markets and in particular where any capacity mechanism exists needs to be carefully analysed to ensure an appropriate set of incentives are created. In particular compensation at £20/therm may not cover the full electricity market exposure of gas fired generators who may be switched off in a real emergency.

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

It would appear that there is still a role for the ECQ to incentivise those suppliers with demand-side contracts to exercise them prior to an emergency or face losing this volume of gas interrupted.

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?

Ofgem's proposals go some way to reducing the impact on the industry and on the credit implications. However, it would appear that introducing a £20/therm cap would introduce an array of credit issues, even before an emergency as they would be taken into account immediately. There could be potential costs on suppliers eg. providing collateral as per margining agreement for commodity trading activities. There would also be an impact on the credit lines (with banks and/or trading partners) and would limit the suppliers activities to add volume to the trading portfolio. The potential cost need to be fully examined to understand if there will be any positive benefit to the GB arrangements and security of supply levels.

This could represent a barrier to market entry and a risk to all suppliers' credit worthiness. Any potential decrease in market numbers and competition should be valued in terms of consumer impact as part of the cost benefit analysis.

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

This may have some benefit given the time taken for invoices to be received and paid is 45 days after an emergency under the Claim Validation Rules (CVA).

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

Enhanced incentives to balance and avoid an emergency could have a positive effect on security of supply levels. This is because both shippers and industrial customers may be more likely to enter into demand-side contracts ahead of time to avoid higher penalties for being short or interrupted on the day.

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

Those shippers short on the day should ultimately pay any compensation introduced. However, on the day there may not be sufficient funds in the pot to pass on and recompense those customers interrupted. This could be caused by suppliers and traders becoming insolvent and the fact that suppliers may be long on the day once their customers are interrupted.

It is not clear from Ofgem's consultation how these problems will be resolved; however, this would appear to be an issue that will need to be resolved if any proposal to compensate consumers is to be taken forward.

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?

It is not clear that there is a gap in the current arrangements. Redpoint's risk assessment shows that the current arrangements are robust and meet security of supply standards in all but one scenario where firm I&C customers may be switched off once in every sixteen years.

Moreover, we believe that a more comprehensive risk assessment with greater clarity and details on the exact assumptions and results would be required to exactly identify and characterise the precise potential problem. In particular this should seek to identify under which assumptions and scenarios the problem can appear, the time horizon of its apparition and progression, its size, duration and the likelihood and frequency of occurrence, etc.

It is not clear whether Redpoint's analysis takes into account the amount of commercial demand-side response that may be available just before and in such an emergency; however, we believe this is an area of work that would benefit from further analysis before determining whether further interventions are needed.

It is also not clear why there is a notable lack of demand-side response in the UK and whether this is because I&C customers are willing to have their supplies interrupted in an emergency or whether they believe there is no risk or a gap in the arrangements. More clarity in this respect might be useful to inform this review and identify any potential solutions.

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

The main set of potential further interventions appears to have been covered; however, we note that there are others which have not been considered at any great length, for example a contract for differences or a capacity mechanism.

These further market interventions are similar to that being discussed in the electricity market under the EMR led by DECC. We recognise that Ofgem has a role to play in helping assess the impact of any such further intervention proposed; however, we believe that this should ultimately be done by DECC who has responsibility for setting and implementing energy policy. This should also help to ensure consistency of policy, approach and analysis.

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?

As previously noted there is a need to clearly identify the standard that is required and the problem being addressed in order to identify the most efficient solution for the market and consumers.

We therefore do not have a preference at this stage or whether any interventions will increase Security of supply levels without damaging the market.

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?

As previously noted increased demand-side response may have a positive impact on security of supply. This may also help to facilitate the identification of the true value of lost load, price discovery and competition for these services, can be achieved.

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.

See Q2 above.

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?

The case for obligations has not been made; however, any such obligation should not be technology specific and should concentrate on the deficiencies, such as the lack of flexibility from LCPD and intermittent generation as DECC's Risk Assessment states. Gas from many different sources can provide security of supply and it should be up to the market to decide which is the most competitive and efficient.

In terms of strategic storage the case has not been made as it appears to be a costly way of increasing security of supply. It will also undermine any current and future investment in gas storage facilities as Ofgem's and Redpoint's assessment point out.

EDF Energy
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