first:utility

GB Markets Team
Ofgem
9 Millbank
London
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January 31st, 2012

Dear Sir,

Gas Security of Supply Significant Code Review – Draft Policy Decision

Please find First Utility's response to the above consultation below.

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 options laid out in the consultation paper seem appropriate.

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

We feel it is appropriate to utilise the VoLL corresponding to the duration and frequency of outages referred to in the gas security of supply standard (i.e. a one week supply interruption with a probability of occurring once in a twenty year period).

Chapter 4: Cash-out Reform

Question 1: Do you agree that it is appropriate to retain the Post Emergency Claims (PEC) arrangements?

We believe that cash out should not be frozen upon declaration of a Stage 2 or greater emergency as this is unlikely to provide the appropriate signals to incentivise gas delivery to the network in situations where it is most needed. If this approach were to be taken the Post Emergency Claims arrangements would no longer be required.

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 are uncertain that domestic customers will consider £20 per therm a suitable incentive. Given that Ofgem's view of average domestic gas consumption is 16,500 kWh annually (which equates to approximately 563 therms), a week's consumption would be equivalent to approximately 11 therms which would equate to £220. Given the inconvenience and potential health risks that might result from a week long interruption of gas supply (which is also likely to be at the coldest time of year) we feel that a higher incentive is likely to be necessary. This is particularly likely to be the case for vulnerable households, which may require a higher incentive than that offered to non vulnerable households. However, we assume that these would in any case be prioritised so that they would be the last domestic properties to be interrupted in an emergency situation.

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

We believe that for domestic properties the VoLL payment would need to have factors other than simply the perceived economic cost of interruption to be taken into account such as inconvenience, health concerns etc and due to this a higher level of VoLL payment will probably will probably required for this sector. However, in the non domestic sector, we feel that £20 per therm would probably be adequate as only loss of production / operation will need to be taken into account.

Question 4: Do you agree that it is appropriate to retain the Emergency Curtailment Quantity (ECQ) arrangements?

Yes, we believe these should be retained as shippers should not be exposed to additional imbalance risk due to Transporter curtailment of gas offtake at any particular site as part of a Gas Deficit Emergency.

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?

While we feel that targeting of this nature provides an appropriate incentive for Shippers to balance themselves in a tight network situation, it could be argued that Shippers supplying domestic portfolios might be more likely to be short at times such as this through no fault of their own due to the actions of their customers over which they have no control. This is likely to particularly negatively affect smaller players as the potential that they may face a risk of this nature should logically lead to higher credit requirements by DNOs. However, we agree with Ofgem's proposal that VoLL payments for short shippers during such an emergency should be based on the first day rather than the full duration and feel that this will go some distance towards addressing our concerns.

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

No, as we believe this is likely to distort the incentive to be properly hedged. Shippers should be incentivised in as direct a manner as possible not to be short during times of severe system stress. As VoLL payments will be based only on the first day of firm interruption rather than the full duration of the outage this should not then be further diluted by allowing extended payment terms.

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

This seems unlikely as we would have thought the proposed guarantees of VoLL payment around firm load shedding would make it less likely that industrial consumers would be interested in agreeing an interruptibility contract with the relevant DNO. In addition, we feel that a guarantee of this nature (particularly if priced at £20 per therm) is likely to lead industrial consumers to place a much higher value on their interruptibility than might be economically efficient for DNOs to accept.

Question 8: Do you agree with our broad proposal for collecting monies from shippers and passing this through to consumers?

We believe that any arrangements of this nature should be dealt with by a third party agent with its activities funded on the basis of market share.

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?

Yes, as, although £20 per therm is a high cap in relation to where gas prices have previously risen during times of system stress (although it is true that it still remains to be seen what would happen in an emergency situation), the market would still not be allowed to find its own level and thus the price signals sent by cash out will be blunted to some extent.

In the event that this cap is reached more than 3 times in a defined period (five years may be appropriate) we would suggest that Ofgem then either revise the VoLL number upwards or simply allow the market to find its own level.

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

These seem appropriate.

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?

These seem appropriate.

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

While we would prefer that the market be left to find its own level in an emergency situation, on balance it would seem that cash out capped at £20 per therm should provide sufficient incentive for shippers to properly balance themselves as this is almost ten times the highest level of cashout previously recorded. In addition, the further interventions proposed by Ofgem should reduce the uncertainty that such a high level of potential cashout may cause although we would emphasise that these interventions, should they be enacted, are likely to blunt short term price signals which may incentivise investment in the future. However, we believe that the abandonment of the current freezing of cash out during an emergency is a suitable step forward.

Please do not hesitate to contact me should you have any questions or require any further information.

Yours sincerely,

Chris Hill

Chris Hill

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