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Gas Security of Supply Significant Code Review - Draft Policy Decision

Gas Forum response

The Gas Forum welcomes the opportunity to respond to the draft policy decision document. In our response we have elected not to answer each of the questions set out in the document, but to provide some general points which we trust will be helpful in informing further policy development.

Objectives of the Review

Before commenting in detail on the proposals, the Gas Forum wishes to highlight the key objectives of the review, as identified by Ofgem:

- minimise the likelihood of a Gas Deficit Emergency (GDE) occurring by encouraging gas shippers and suppliers to take out sufficient investment to ensure gas security of supply;¹
- minimise the severity and duration of a GDE, if one ever occurred, by sharpening incentives to attract gas into Great Britain (GB); and
- compensate firm consumers if they are ever interrupted due to a GDE.

In our opinion the intent, although not necessarily the application, of the first objective is of greatest significance insomuch as it is not in the interests of UK consumers to experience a loss of supply. Mechanisms must be put in place to ensure that the potential for a GDE is minimised. It is with this objective in mind that we have considered the detail of our response.

Key messages

In common with the view expressed by the Forum at the SCR seminar held in December 2011, we are disappointed that Ofgem seems determined to adopt a piecemeal approach to the issue of security of supply.

At the highest level, the Gas Forum is unconvinced that the case has been made for reform in this area. We are concerned that Ofgem has unilaterally determined that

¹ Note: the review is aimed at reducing the likelihood of a GDE occurring due specifically to insufficient supplies

the current arrangements are not fit for purpose and radical changes need to be introduced. The Gas Forum understands that it is appropriate to monitor the security of gas supplies, but it does not believe that Ofgem has presented a robust case for change.

Beyond the need to justify **any** changes to the current mechanism, the Gas Forum is highly critical of the process established by Ofgem.

By its own admission, Ofgem considers that the proposals are not fully developed and further work is needed to establish the requirement for, and the form of, further interventions. The Gas Forum concurs with this view, but not for the same reasons. Ofgem believes that the SCR proposal – that relating to VoLL and cash-out – is justifiable in isolation and that further interventions should only be considered as a means to “plug the gap” created by the limitations on compensation recommended during Stage 3 of an emergency. The Gas Forum is firmly of the view that, although Ofgem is correct in its assertion that the SCR will not fully satisfy the primary objectives, the strong interactions between the SCR proposal and potential further intervention measures are such that it would be wholly inappropriate to consider the two components as being related and part of an overall solution.

We cannot stress enough the real concerns of our members that Ofgem is positioned to rush through a SCR proposal which even now is uncovering new issues and growing in complexity. Ofgem concedes that the proposals are not fully developed; this was never more clearly demonstrated than at the workshop of 23rd January, and there is still a long way to go.

Gas Forum members have reached a broad conclusion that the SCR proposals are fundamentally unsafe in the sense that they will unlikely succeed in delivering against the principal objective of significantly reducing the likelihood of a GDE. Moreover the application of such terms (assuming details could be satisfactorily be developed) to any actual GDE would likely result in a negative outcome for the UK market after the grid was restored to normal conditions. The resuming “market” would be composed of a smaller number of competitors, declining liquidity at the NBP and poor price transparency, in turn, increasing the risk of subsequent GDEs. The Gas Forum has concluded that it simply cannot see how it could agree with Ofgem’s view that the SCR proposals will make a positive contribution to security of supply and that alternative solutions(s) will still be needed to meet that objective.

The Gas Forum’s overriding messages are:

We are not convinced of the need to introduce any changes to the arrangements at the current time; and

In the event that Ofgem continues along the path it has determined on a unilateral basis, then we believe that it would be prudent to defer any decision relating to the introduction of the SCR proposals until such time as a full

appraisal of the intervention measures has been completed. In addition, we would expect that the appraisal would review the full impact of the intervention measures independent of the application of the SCR proposals.

Detailed comments

Cash-out reform and VoLL

The Gas Forum is unconvinced that the proposed changes to cash-out and the introduction of a VoLL compensation scheme will assist in the fulfilment of the main objectives for the following reasons:

- It is assumed that shippers will be able to respond to the price signals in all cases. In some cases this maybe the case, but in others not, depending on; the “speed” of the emergency; the availability of alternative supplies and/or DSR; and credit lines available to shippers etc...
- A cash-out cap may lead to a more rapid escalation of prices, towards the cap.
- It is assumed that shippers will seek to insure against low probability, high cost events. This may be the case in some instances, but not all.
- Ofgem assumes that in the event that the market does elect to “insure” against a GDE it will do on the basis of, primarily, DSR contracts. The Gas Forum is concerned that sufficient DSR volumes may not be available due to; strike prices will tend towards the domestic VoLL and be unattractive to shippers; and customers will not want to enter into multiple year contracts with shippers.
- The levels of cash-out and compensation will lead to rapid escalation of shipper debt and credit erosion. Rather than reducing the likelihood of a GDE occurring, the mechanism may simply lead to shipper insolvency and market malfunction.

Intervention measures

- The Gas Forum is generally opposed to any form of PSO being applied. In our opinion, such a measure may be acceptable in a non-functioning or semi-functioning market where, in particular, storage facilities are owned and operated by a limited number of entities. This is clearly not the case in the UK. The UK market has delivered a number of independently owned storage facilities and PSO’s will lead to “stranding” of capacity and crowding out of private investment. The Gas Forum urges Ofgem to recognise the significant levels of investment in UK infrastructure in recent years (over £5bn in 5 years) and not to endanger future investment through the application of PSOs.

We hold little store in the view that an Information Provision obligation would deliver genuinely useful information. We expect that Ofgem is fully aware that the complexities of supply arrangements are such that any information provided by shippers/suppliers would be difficult to assess and contrast with security of supply targets.

Yours sincerely

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Richard Fairholme – Chairman, Shipper Workgroup