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Gas Security of Supply Significant Code Review - Draft Policy Decision November 2011

Dear Anna,

Thank you for the opportunity to comment on this matter. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

We have carefully considered the proposals set out in the Draft Policy Decision for changes to the current gas market arrangements to enhance security of supply. We give detailed responses to the questions in the attached appendix and a summary of the main points below.

Ofgem has identified three key policy objectives:

1. 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
2. Minimise the severity and duration of a GDE, if one ever occurred, by sharpening incentives to attract gas into Great Britain (GB); and
3. Compensate firm consumers if they are ever interrupted due to a GDE.

The current uncapped cash-out arrangements provide strong incentives on shippers/suppliers to balance supply and demand. These arrangements are already leading to investment in LNG import terminals, increased interconnection and storage projects. Ofgem's proposal is to introduce an administered Value of Lost Load (VoLL) into cash-out once firm load shedding occurs as a proxy for the demand-side setting the cash-out price for short shippers. In our view, sharpening price signals in the current cash-out arrangements in this way could deliver further investment in both demand and supply side solutions to improve security of supply and help to meet objectives 1 and 2.

We strongly disagree that demand-side response (DSR) should be compensated on the basis of an administered VoLL. This approach not only introduces significant implementation challenges but, more importantly, will result in an outcome that is contrary to Ofgem's overall policy intent.

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The key assumption that underpins the modelled benefits of the policy is that it will create incentives for customers to sign commercial interruption contracts with shippers and these will be exercised to prevent or limit a GDE. We agree that following removal of transportation interruption following exit reform means that it is important for large firm DM customers to be included in the arrangements via commercial interruption mechanisms.

In previous consultations on gas cash-out, Ofgem has highlighted the theoretical perverse incentive for shippers with a negative imbalance to accelerate the declaration of an emergency by not purchasing gas available from non-domestic sources as short shippers may prefer that an emergency is declared so that the cost of their imbalance is frozen. Similarly, administered price compensation at VoLL may weaken incentives on customers to negotiate contracts to deliver services ahead of an emergency and arguably strengthen the incentive for customers to seek compensation at VoLL rather than take action to prevent an emergency.

We are not in favour of market interventions, but one way to address customer's apparent reluctance to enter commercial interruption contracts would be to develop a DSR auction or tender where National Grid Gas was the counterparty. This should be a last resort mechanism within the scope of the present market arrangements. It would only be used in defined circumstances once all other solutions had been used to prevent a GDE. Remuneration of the gas under a contract would be outside the cash-out mechanism with recovery of the costs from all customers on non discriminatory terms that do not distort wholesale or retail competition.

Although its focus is cash-out, Ofgem's preference is to supplement cash-out reform with further interventions to close a gap that it sees from capping VoLL. Our concern is that any intervention will introduce inefficiencies into the market that could, if not properly designed, result in a reduction rather than improvement in benefit. This is evidenced by Ofgem's own Impact Assessment and the wide and uncertain range of costs it contains. The practical implementation of Ofgem's proposals has not been properly considered. Once load shedding or isolation has been initiated, the system will swing from being short to long and this raises the question of how to target costs. It will require a new mechanism to fix shippers' imbalance at the point the emergency is triggered. In our view, the compensation pot will inevitably be in deficit as NGG will interrupt in tranches that are unlikely to exactly equal the aggregate short position. The document is silent on how this deficit will be funded, but any smearing will weaken incentives on individual shippers. The proposed cash-out and compensation arrangements will create significant financial and credit issues for short shippers which in turn could lead to shipper insolvency. We do not believe that Ofgem has satisfactorily considered this in its draft decision.

We are further concerned that the two stage approach (reform cash-out and then develop further interventions) is inefficient and it would be better to develop and implement a single solution. DECC's security of supply analysis [1] notes that *"in the short to medium term, the UK gas supply infrastructure is resilient to all but the most unlikely combinations of severe infrastructure and supply shocks"*. This suggests that there is sufficient time to develop and implement the most efficient and cost effective solution.

To conclude, our priority would be to improve the signals that come from the present cash out arrangements with a minimum level of further market intervention. The demand-side is important, but it should be a matter for customers and shippers to determine the value of providing the services, possibly alongside a Last Resort Mechanism managed by the SO.

We hope these views are helpful and if you wish to discuss any aspect of them in further detail, please do not hesitate to contact me.

[1] Risk Assessment for the purpose of EU Regulation 994/2010 on security of gas supply, November 2011

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

ATTACHMENT 1: 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?
Ofgem has considered a full range of options and we agree that it is appropriate to use the EU regulation as a basis.

Question 2: Do you agree with our approach to setting the level of security of supply?
Ofgem's proposal is to use the VoLL that corresponds to the desired security standard to set the level of cash-out and/or a further intervention, rather than define a target level of security. We agree that market-based mechanisms should be allowed to deliver security of supply as in the GB market security of supply is primarily delivered by incentives on market participants to balance their inputs to and off-takes from the gas pipeline system. This allows market participants to determine how best to meet these obligations. It should be noted however, that the GB market comfortably exceeds the infrastructure and supply standards required by EU Regulation 994/2010.

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.
Yes. The PEC arrangements provide an incentive to deliver additional gas into GB during the GDE. Although not raised explicitly as part of this consultation, a single cash-out price would provide more certain remuneration of incremental gas. However, a single price approach may work better with dynamic rather than administered price setting.

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 London Economics analysis sets out a range of VoLLs for different types of end-user, but there is little justification for using domestic VoLL other than it being high and simplifying the arrangements by not including multiple VoLLs. Ofgem's proposed £20 per therm is at the high end set out in the London Economics analysis. Our concern about the proposed level of VoLL is that it provides significant over-compensation for end-users with a VoLL lower than the domestic VoLL. The distortions created by this are not fully considered in the draft policy decision. We disagree that customers with a low VoLL relative to domestic VoLL will have strong incentives to negotiate interruptible contracts. Our view, supported by many years of anecdotal evidence and from the DN interruption auctions, is that these customers prefer to be firm and will hold out to be interrupted at the administered VoLL. Rather than using a higher VoLL, price discovery could be improved via a demand-side tender.

Question 3: Is one day domestic VoLL an appropriate administrative price for any firm load interruptions?
We strongly oppose introducing an administrative price for firm load interruptions. Introducing an administered price will remove incentives on end users to negotiate contracts to provide DSR at anything less than the administered price or they will wait to be interrupted.

Question 4: Do you agree that it is appropriate to retain the Emergency Curtailment Quantity (ECQ) arrangements? If not please explain why.
Yes, they should be retained to ensure shippers imbalance positions following emergency curtailment are billed and accounted for correctly. We do think however, that National Grid should ECQ arrangements should be tested as part of its annual emergency test exercise. Customers that are interrupted to manage a GDE will not necessarily be customers of short shippers. Shippers that

dominate the large and very large DM sector are less likely to have customers in the NDM and SME sectors[2]. There is also a requirement for an analogous mechanism to apply in the smaller NDM sector following network isolation. Shippers' imbalance position at the point of isolation needs to be recorded as, at the end of the gas day following isolation, shippers to NDM customers are likely to be long as demand is removed.

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?

Limiting the exposure to day one only of a stage 3 interruption does reflect the time that network restoration will take and the lack of shipper involvement in the process. However, including NDMs that are part of isolated networks overly complicates the process Basing SMP buy and DSR payments on a VoLL of £20 per therm will still generate significant costs. The proposals do not alleviate fundamental concerns about the credit implications and possible "contagion" caused by shipper failure.

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

The detailed implementation of the proposals set out in the Draft Policy Decision has yet to be properly developed with at least two options on the table. There will be significant cash-flows to be calculated, apportioned and collected. We agree, in principle, that cash-flows need to be aligned and that this is a prerequisite if the neutrality mechanism is utilised as it relies on matched flows in and out. Protracted timescales post emergency will increase credit risk as shippers' exposures will need to be factored into credit requirements.

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

In principle, we agree that the pricing signal will provide incentives to avoid an emergency occurring or at least being short during the emergency. Shippers already deploy various measures such as procurement of storage, securing long-term supply contracts or contracting for demand-side response. We strongly believe that setting an administrative price for any firm load interruptions will have the opposite effect and DM customers that could provide DSR will simply wait and receive VoLL. It is not lack of incentives, but lack of customer appetite to sign commercial interruption contracts

We see a potential role for a Last Resort mechanism within the scope of the current market arrangements, where National Grid could contract (via shippers) through a DSR tender. Under this mechanism, the focus would remain on shippers solving the problem, with the last resort arrangements only deployed in clearly defined circumstances once all other solutions had been utilised.

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 do not agree that there should be an administered price paid for firm interruptions and therefore such a payment mechanism is not required. Remuneration of any interruptions should be outside the balancing mechanism i.e. providers will not receive the capped cash out price Where contracts are with a shipper, then payment terms will be part of that contract.. If it is via a last resort contract with the SO (via a shipper) then the costs will be recovered through the SO commodity charge

CHAPTER 5: POSSIBLE FURTHER INTERVENTIONS

[2] 2010 GREAT BRITAIN AND NORTHERN IRELAND NATIONAL REPORTS TO THE EUROPEAN COMMISSION

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 not agree that there will be a gap. In our view, sharpening price signals from the current cash-out arrangements will be sufficient to deliver further investment in both the demand and supply side that will enhance security of supply. The GB market already comfortably exceeds the infrastructure and supply standard laid out in the Security of Supply Regulation 994/2010 and is widely regarded as the benchmark for a competitive, liquid and efficient wholesale gas market, which the rest of Europe aspires to. Any further intervention is wholly disproportionate and will create distortions which are not only detrimental to the GB market itself but which will damage the high reputation it currently has throughout the rest of Europe.

Question 2: Have we captured the full set of potential further interventions? If not what other further interventions should be considered?
Ofgem has set out a comprehensive range of further interventions The consultation lacks sufficient detail on the interventions and only the most extreme storage intervention has been modelled. We would like to see a last resort option fully worked up, where the SO contracts, via a DSR auction or tender.

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?
We would expect there to be benefits from sharpening cash-out prices faced by shippers, with uncapped VoLL (option 1) leading to higher benefits than capped VoLL (option 2). This is borne out in the analysis. We also agree that the design of any further intervention is critical to any benefits (or costs) that arise. Ofgem is silent on what its preferred level of security is, so it is difficult to assess the extent to which the combination of policy options actually meet Ofgem's objective. Ofgem has not considered the implementation costs of its proposals, especially where additional industry processes need to be developed. We also think that Ofgem has underestimated the potential impact on industry credit requirements and insolvency.

Question 3: Do you agree with our assessment on a preferred option?
The aim of the policy must be to deliver the most cost-effective solution to GB consumers. It is not clear that Ofgem's preferred option meets that objective as a storage intervention is the most distortionary and expensive. Furthermore, we are concerned that the two stage approach (reform cash-out and then develop further interventions) of Ofgem's preferred option is inefficient and it would be better to develop and implement a single solution.

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 support further interventions, but our initial view is that, following exit reform it is important to focus including the demand-side. Our strong preference is for no further interventions to avoid undermining investment because of increased regulatory risk.

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?
We are not convinced that they will necessarily help. Our experience is that customers are generally not interested in offering commercial interruption. This reluctance is a combination of preferring a firm contract and mismatches in valuing any service between the customer and shipper. We would welcome further clarity on Ofgem's thinking around these contracts.

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 think that if the SO was involved as counterparty and that any contracts could only be exercised as a last resort to prevent an emergency once all other solutions had been fully utilised that this would address a number of the concerns. Some of the challenges identified, such as pricing structure, will need to be resolved no matter the nature of any auction or tender.

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?
We do not support any form of storage obligation or the development of strategic storage. If the market values storage as a way to mitigate its exposure to cash-out risk, then projects will be brought forward.