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Gas Security of Supply Significant Code Review - Draft Impact Assessment November 2011

Dear Andrew,

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.

Modelling low probability high impact events is not easy, especially when a GDE has never occurred in the GB market. This makes it difficult to test whether the solutions suggested by the modelling will be robust in practice and the anticipated behavioural changes realised. While we agree that the modelling provides a helpful insight, it sets but one set of results that would be different given a different set of input assumptions. Our strong view is that the fundamental assumption about the incentives created by including administered compensation at VoLL for customers is incorrect and that this undermines much of the cost-benefit analysis and weakens the strength of any conclusions that might be drawn.

Our detailed responses to the consultation questions are in the attached appendix.

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.

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

ATTACHMENT 1: CONSULTATION QUESTIONS

CHAPTER 1: BACKGROUND AND OBJECTIVES

Question 1: Do you agree with our modelling approach and the assumptions we have made?
We are not in a position to critique Redpoint's modelling but the approach appears to be acceptable. It is always necessary to make assumptions and these will drive the modelling outputs. Equally credible assumptions, will give a different set of results and Redpoint has attempted to recognise this by undertaking sensitivity analysis around the key parameters.

Question 2: Are there any other limitations to our modelling approach that have not been accounted for?
The fundamental limitation is the assumption about the incentive properties of VoLL compensation leading to a growth in commercial interruption contracts. These are the main driver for reduction of firm DM customer interruptions and improvements in security of supply. We believe that the policy to incorporate a VoLL-based administered compensation payment for firm customers is flawed and will only produce marginal benefits at best. The analysis should be extended to consider the counter-factual that DSR contracts will not be signed.

Question 3: Are there additional sensitivities that we should consider for our final Impact Assessment?
Gas-fired generation is the largest provider of flexibility to the gas system. Electricity market interactions should be included within scope of the analysis. This is particularly important as gas-fired generation will become increasingly important over the period to 2020 and beyond, both for delivering replacement capacity for that closed under LCPD and IED and to provide back-up to increasing intermittent generation that is expected to connect. A scenario where there is a peak electricity demand day coincident with a GDE should be included, with sensitivity with and without non-generation DSR contracts available.

CHAPTER 2: IMPACT OF REFORM OPTIONS

Question 1: Have we fully captured the key impacts arising from our reform options?
There is considerable additional work required to develop and implement the cash-out reforms and until this has been completed, it is hard to assess the impacts. Additionally, the further interventions (except a storage obligation) have yet to be modelled and their interaction with cash-out reform assessed.

Question 2: Do you agree that capping cash-out as proposed under options 2 and 4 will significantly reduce the risk of adverse consequences for competition?
We agree that capping cash-out to one day's domestic VoLL following network isolation is better than exposing shippers to a multiple of one day's domestic VoLL but our fundamental concerns about the consequential adverse impacts of the absolute level of VoLL remain. The level of level of possible financial exposure together with shipper uncertainty about their own imbalance position will, we believe, significantly reduce the extent of shipper to shipper trading as shippers will seek to protect their own position.

Question 3: Do you believe that our modelling under or over estimates consumer price increases?
The impact on consumer prices is uncertain, although intuitively one would expect increased upward pressure on costs. The modelling sets out a huge range of potential costs and the storage intervention in particular is an expensive option both in direct costs and in the distortions it would create in the storage market and any impacts on liquidity. Shippers will put in place a variety of measures to "insure"

against being short in a GDE given the level of cash-out price proposed. These additional costs are unlikely to be competed away.

Question 4: Can you provide further evidence on the impact of our reform options on competition, in particular in relation to financial distress, credit requirements and barriers to entry?
It is difficult to provide concrete data in this regard. However, modest increases in gas costs in the past have led to shipper/supplier failure. Given the considerable additional potential exposure to cash-out at £20 per therm, it is not unreasonable to conclude that this will increase the risk of financial distress, either from sourcing additional gas as the market trades up towards VoLL or having a short position cashed-out post-emergency. There will be a consequent increase in security based upon £20 per therm that market participants will need to put in place.

Question 5: Can you provide information on the costs of implementing the proposed reforms, such as system changes and staff training?
We would need additional details to develop meaningful implementation costs.

Question 6: Have we effectively modelled interactions with other markets?
Interactions with the EMR are stated explicitly as out of scope. Given our concern that Ofgem's preferred approach will not result in an increase in DSR contracts, it is likely that CCGTs will be required to reduce offtake. This will weaken rather than enhance electricity security of supply in the electricity market as argued by Ofgem.
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Question 7: Do you agree that the use of interruptible contracts will be encouraged through a reform of the cash-out arrangements?
No. We strongly believe that setting administered compensation payments 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 this is the issue.

CHAPTER 3: CONCLUSION

Question 1: Do you agree that option 4 is the best option?
No. We support the improved signals that come from cash out by introducing the risk of VoLL for short shippers will improve security of supply. We do not support the proposal to introduce an administrated compensation at VoLL for DSR. If any additional measures are deemed necessary, we see merit in developing an NGG facilitated DSR tender to contract for gas that would only be called on a predefined last resort.

Question 2: Do you think that table 12 provides an appropriate assessment of the reform options?
It is extremely difficult to draw strong conclusions based on this type of RAG presentation of the reform options.