BG GROUP'S RESPONSE TO OFGEM'S SIGNIFICANT CODE REVIEW – FINAL PROPOSALS

We support reform of cash-out in the event of an emergency and consideration of other potential measures such as centralised co-ordination for Demand Side Response (DSR). However, whilst we have acted constructively during the whole SCR consultation process, we believe that the proposed SCR solution based around £20/th VOLL is flawed and if imposed, will be very damaging to the GB gas market. We therefore request a suspension of the Ofgem SCR process and that the Centrica Modification UNC0435 is permitted to be developed so that an industry-led solution is implemented to address the objectives originally set out.

In this response, we set out why we believe the Ofgem SCR proposal is so damaging. The final draft decision document states that Ofgem is unlikely to change policy direction unless there is new evidence. In this response BG is highlighting three areas that are either new or have not been adequately considered in the proposals, namely:

- Risk of price contagion in EU markets
- Introduction of practices contrary to European Security of Supply regulation EC994/2010
- Adverse impact of neutrality on the incentive to bring in new sources of supply

Our response then considers the application of VOLL and contrasts that with a dynamic cash-out approach which is likely to be consistent with Ofgem's SCR objectives. We conclude our response with comments on implementation measures raised during this summer's consultation process.

SCR will damage GB gas market liquidity

We believe that the imposition of a £20/th VOLL that is triggered in the event of a Gas Deficit Emergency will not deliver any improvements in security of supply or reduce the likelihood of a GDE occurring. However, we believe that it will damage market liquidity, reducing the forward selling of gas, especially during periods of potentially high demand. This will lead to greater price volatility, less certainty for the retailers and higher prices for end-users, well beyond the £0.11/a quoted in the Ofgem impact assessment.

The GB market is very fortunate to have a deep, liquid NBP virtual hub and its existence has attracted new infrastructure investments into the GB market. Yet the SCR proposal is likely to needlessly damage this liquidity through the introduction of the threat of an extreme administered price. The calculations behind VOLL are fundamentally flawed and we tackle that towards the end of this document. But the continued insistence on price in the event of an emergency will create unwelcome changes in the market that hamper market liquidity well before an emergency ever takes place.

New evidence

We note that in your final draft policy decision you are unwilling to consider changing your decision unless new evidence is presented. We believe that there are a few issues that have not been considered or given due consideration in this process and this lends support to using the Modification route rather than Gas Act powers to implement the appropriate solution.

VOLL leads to price contagion in NW Europe?

Our primary “new” concern is that the proposals will potentially introduce price contagion in North West European markets ahead of and during an emergency, creating further market chaos.

The images below show market behaviour ahead of and during an emergency in the event of an emergency in the GB market or one that impacts NW Europe.

Price contagion in the event of a GB only gas supply emergency

Normal	Pre-emergency (GBA)	Emergency
Strong price correlation	Prices in GB rise	£20/th VOLL invoked
Efficient use of IUK/BBL	Import flows maximised	Risk of IUK curtailment?
	IUK in import mode	Steep price rises in NWE potentially to ~ £20/th

In the GB only emergency, one can anticipate supplies being maximised through the Interconnectors and market prices on the continent rising sharply to just below the £20/th or €860/MWh as short shippers in the GB market would be prepared to pay to avoid the administered price. This distorts the short-run functioning of connected continental markets (e.g. linked to prices that their consumers might pay), and represents a welfare transfer from the GB economy caused entirely by the arbitrary setting of VOLL at £20/th.

If there was a gas supply emergency that also impacted NW European countries, there are a couple of potential outcomes. The more likely result, is that the GB market will not get the gas it requires, for one of two alternative reasons: the price cap would work against it – i.e. other affected markets with an LNG terminal (eg Gate, Montoir, Dunkerque, Zeebrugge, Spanish, Italian etc) could be paying £20.10/th and the cargo goes there, rather than a GB import terminal; or the existence of the emergency triggers interruption of imports through the interconnectors through TSO emergency measures, exacerbating the price differential between markets (remaining around £20/th in GB and potentially dropping considerably within day in NW Europe as 100+mcm/d remained on the continental side and there are distressed sellers from the GB markets who previously had been importing gas).

Gas emergency affecting NW European markets

Normal	Pre-emergency (GBA)	Emergency
Strong price correlation	Prices in GB rise	£20/th VOLL invoked
Efficient use of IUK/BBL	Import flows maximised	IUK curtailment from Belg.
	IUK in import mode and steep rise in NWE prices.	NWE prices < £20/th as no physical linkage to GB

Furthermore, an emergency affecting other NW European countries would be managed under the Security of Supply Regulation EC 994/2010. We are not clear why greater reference is not made to this in the SCR proposals as this should be central to the policy effect. Under Article 2, customers will be classified as protected or non-protected and one of our concerns is that the Interconnectors, at the time maximising imports of gas into the UK market, could be interrupted, leading to cessation of Interconnector flows by the TSOs. This would sever the linkage with GB markets and there would likely be a significant price differential between the trading hubs, with the GB market effectively isolated for pipeline gas.

We look forward to hearing back from Ofgem on these two specific points re price contagion in NW Europe (and whether there have been detailed conversations on the SCR proposals with fellow European regulators NMa and CREG) and the impact of VOLL on UK's compliance with the Security of Supply Regulation.

£20/th VOLL is the problem

The industry has generally understood the need for reform of cashout in the event of an emergency, but it is the £20/th VOLL price that we consider so damaging. Ofgem's view is that this is a strong incentive to get market participants to ensure adequate security of supply. The industry's general view is that the presence of this price, given the very low probability event, will not lead to new infrastructure being developed on the back of this risk – simply the risk profile has increased for selling gas forward during peak periods and there is significant neutrality risk in the event that an emergency does occur and supply companies are forced into bankruptcy.

It is important to recognise that industry support for a centralised DSR solution as discussed by the Centrica modification and Gas Forum discussions, are predicated on market based cashout, not £20/th VOLL. Centralised DSR with £20/th VOLL leads to a very flawed solution, where DSR customers would simply bid in around £20/th exercise price rather than reflecting the economic opportunity cost. Given that those costs are likely to be recycled through Neutrality charges (given revenue recovered is likely to be less than compensation payments to customers), we strongly object to "entry" shippers having to subsidise excessive pricing from "interruptible" customers following rational behaviour (ie, I am going to charge close to £20/th exercise price because my competitor down the road is not going to voluntarily interrupt and he will get £20/th compensation when ultimately interrupted). The £20/th VOLL proposal (rather than setting VOLL at market-related prices) becomes an "Easy Money" Charter. It is therefore critical that Ofgem immediately, publicly and clearly "bursts the bubble" of £20/th expectations that customers currently have. It is not realistic, it is very damaging to the market and it is flawed in derivation.

The calculation of VOLL is also fundamentally flawed. It is being calculated on the basis of a relatively small sample size, the domestic 1:20 peak winter compensation required, divided by the annual daily average consumption, not the corresponding peak daily consumption. Given Ofgem's view that the current probability of an emergency is less than 1:20, this should also be reflected in the numerator reflecting a 1:55 value rather than taking a 1:20 figure. As a consequence, we would suggest that if an administered VOLL is chosen, then it should be calculated on this basis, probably giving a figure of less than £5/th. It should also be recognised that even a domestic household is consuming many therms on a peak winter day – a large detached house is probably using at least 5 therms on a peak winter day, so under Ofgem's proposal, such an interrupted consumer would expect a single day compensation if interrupted of around £100 from the supplier. This is probably in excess of what was envisaged under the proposal.

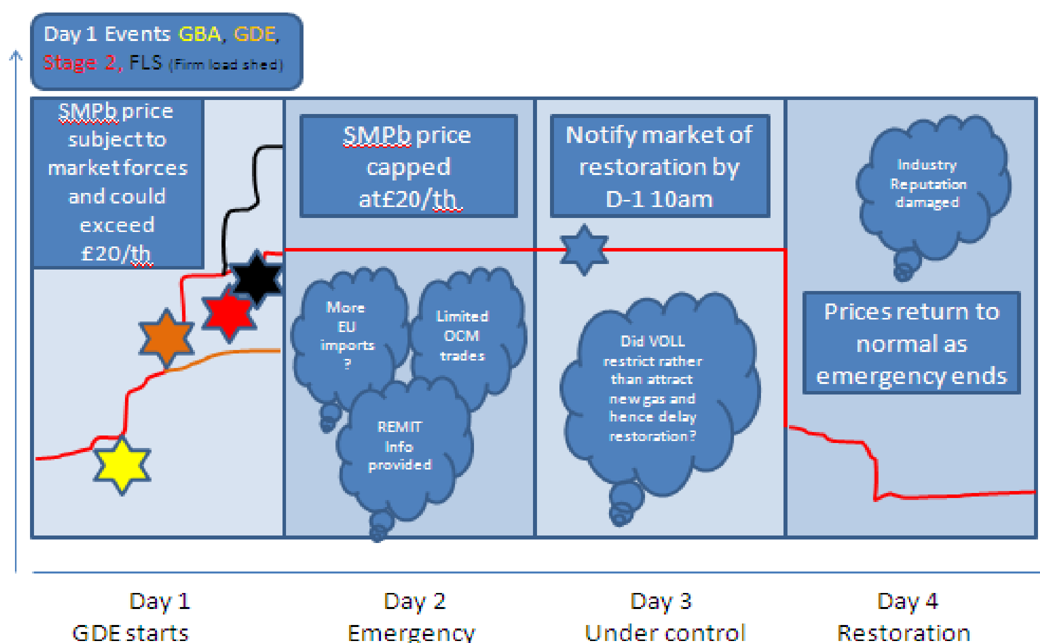
Unfortunately, these "excessive" compensation arrangements need to be paid for, and during the industry discussion on implementation of the SCR, it was apparent that there is likely to be a substantial shortfall against the compensation expected to be paid to consumers. This shortfall is proposed to be recovered through general Neutrality

(throughput on entry and exit flows). This acts as a direct incentive to not bring in additional gas given the uncertainty as to what the level of neutrality charge could be. Shippers will not try to be long and receive SAP when they will be hit by an unknown and uncontrollable cost. Will Ofgem accept additional PEC claims to cover a shipper's additional costs from Neutrality charges? Given that is unlikely, please recognise that it is a very significant dis-incentive to bring in additional gas given the unknown neutrality charge that it will attract. A £220m shortfall spread over a winter day's consumption that has seen 150Mcm/d lost to the system (ie post emergency flow of 300Mcm/d level of demand and supply) would potentially equate to £1/th neutrality charge that would be applied to all flows.

Dynamic cash-out is a better route

Our opposition to the VOLL is the incorrect price level that is being proposed that represents an extreme but unreasonable risk to market participants. But we are disappointed that Ofgem feel that it is necessary to rely on an administered price. We advocate leaving the price to be dynamic, to reflect market conditions. Obviously this must be made to work within the existing HSSE regulations, but by keeping the market open and NGG able to take physical gas supplies as they are made available to the market, should improve this – the current alternative would be to reply on the PEC (Post Emergency Claim) process. This presents uncertainties that may dissuade shippers from providing gas to the GB market

The diagram below indicates what we believe will happen in the event of a GDE under Ofgem's current SCR proposal.

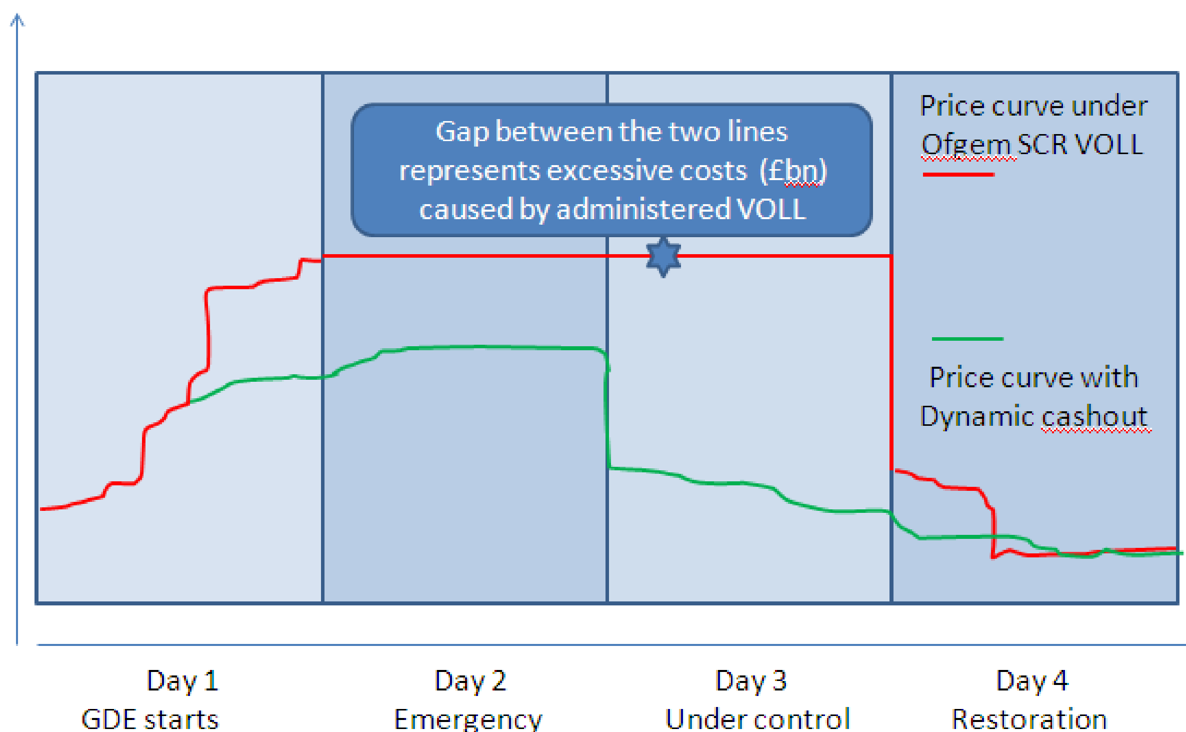


The Y axis represents price and the red line represents the price expectation over a 4 day period, from the start of the emergency to the system getting under control and resumption of the market.

The events reflect the occurrence of significant supply losses on day 1, starting with a "Gas Balancing Alert", followed by the declaration of a Gas Deficit Emergency and then Stage 2 and firm load shedding later that evening (effective 2 hours later). The next day, prices are capped at £20/th and that continues before the network is brought back under control later that evening. The proposed rules limit the next day market restoration until notification before 10am D-1 – we believe this is excessive and would suggest that restoration can be declared later on a day ahead stage (sometime between 2 -4 pm D-1).

The diagram also includes some of the issues (bubbles) that pertain whilst the VOLL price is invoked. Taking measures to ensure that a Gas Deficit Emergency is prevented from occurring should be the priority, because if it does happen, then there is likely to be reputational damage to the sector.

In contrast, we believe that a dynamic cashout price will be much more effective in limiting the duration of an emergency and reducing the economic damage. We fundamentally believe that even in a full blown emergency, prices would not reach £20/th if left to the market. Now Ofgem have introduced that thought to the market, if implemented, this will become the future risk and aspiration target for shippers and interruptible customers/ traders respectively.



The diagram above reflects a schematic of how we see the evolution of an emergency under the Ofgem VOLL case (as outlined above) and then with the market kept open. Prices are at a lower level and the market is able to be restored much earlier. Obviously this is a subjective view, but we consider the differences are plausible, and help illustrate why we

are so concerned with the Ofgem proposals (given the strong industry representations to date explaining the issues with the £20/th).

The lower level of prices with market cashout aids market trading, because at £20/th, trading of imbalances (as opposed to provision of incremental physical gas) will largely dry up due to credit and bankruptcy concerns. This is one of the implementation factors that has not been properly addressed in the Impact Assessment or the business rules.

One other important feature that needs to be developed is a centralised Demand Side Reduction scheme. We need those customers who are able to be interrupted (including tranches rather than full isolation) to be able to contract with a central party, based upon the receipt of an option fee and exercise prices that reflect the consumers' opportunity costs, not linked to an administered cashout price. The details of this should be developed through the Centrica modification, but the cashout price should be set based upon the exercise prices of the consumers interrupted (or market balancing actions where higher). The option fees should be recovered via exit commodity charges given that the benefit accrues to consumers who will remain connected to gas supply.

Conclusions

We trust that the arguments presented in this response are sufficiently compelling to help justify a change in the draft final policy decision. In particular, we consider it is essential that Ofgem move away from the administered £20/th, to a more market-based cashout price, with end-user compensation linked to that. The detail of this still needs to be worked out, but we believe that this should be achieved with the industry through Modification 435. Ofgem will be able to get a solution that has industry support but meets the objectives for preventing a gas deficit emergency in the first place and is capable of implementation well before Winter 2014 (stretch Winter 2013).

We look forward to DECC publishing their "further intervention measures" next month, but we believe that it is essential that Ofgem quickly notify DECC on how your analysis would change in the absence of £20/th VOLL. This should be incremental analysis, but it needs to be recognised that the value of the report to DECC is devalued when such a distortive mechanism is considered to be in place.

The industry is keen to ensure that the appropriate solutions are put in place to prevent a Gas Deficit Emergency and previous consultations have alluded to those solutions. However, we have been frustrated that the process during 2012 has been to push ahead almost regardless, with very little recognition of the industry concerns. We hope that this consultation has led to the clarity of message for Ofgem to understand the risks rather than benefits that the current SCR proposal would impose for the GB gas market and consumers.