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Subject: Comments to the Gas Security of Supply Significant Code Review (SCR) Proposed Final Decision

Dear Tom, Anjli and Tom,

BP is pleased to provide two overarching comments on Ofgem final proposed decision on the SCR, which we can summarize in the following statements:

- We would welcome Ofgem suspending the implementation of SCR until it looks in the round at the Gas Forum led DSR auction proposal and the completion of Government Security of Supply (SoS) review. On this basis, we welcome Ofgem's communication issued on 23 October 2012 which we understand suggests such a possibility.
- With regard to the detailed implementation of VOLL, we would welcome a reassessment of the proposed neutrality arrangements. Our main concern is the risk of exposing shippers in general to insolvency of other defaulted shippers once a GDE escalates to stage 2, and especially the risk of having long shippers who contributed to reducing the severity of a GDE absorbing liabilities of defaulted shippers.

About suspending the SCR until alternative solutions are fully considered

We have noticed Ofgem's determination to pursue implementation of a new VOLL-based short imbalance cash-out during a Gas Deficit Emergency (GDE), regardless of the concerns expressed by industry around the actual costs and benefits of the measure. BP appreciates at high level the economic rationale underpinning the proposal of an egregious cash-out for short positions during a GDE. On the other hand we are convinced that the differences between this rationale and the imperfect commercial reality of gas markets could significantly reduce the benefits Ofgem expects from VOLL.

More specifically, BP's view on the capacity of the proposed VOLL emergency cash-out to achieve Ofgem's reform goals is that it:

- Would provide a basis for compensation to firm customers interrupted during a GDE, as desired by Ofgem.
- Would not improve the current levels of SoS, (either by triggering anticipated financial and/or physical hedging on the supply side – especially through investment in storage - or by increased commercial interruption on the demand side).

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- Would be unlikely to trigger measures for a speedier resolution of a GDE than under current arrangements

As explained in more detail in previous BP SCR contributions, the key reasons for the above expectations are that a VOLL emergency cash-out:

- Is heavily decoupled from the real pricing and willingness to pay resulting from gas market dynamics, and could distort the functioning of the GB gas market by making financial exposure unmanageable during a GDE
- Could paradoxically reduce the current level of SoS, by adversely affecting NBP liquidity and gas supplies when most needed, both in the short term as producers stop selling forward during the GDE, and in the longer term by pushing trades back to the beach
- Could provide over-insurance as it fails to distinguish between different customer categories for the purposes of compensation
- Ignores synergies between SoS measures and increases the risks of gold-plating the system, by deciding *a priori* that VOLL is an additional and not an alternative solution to the further measures currently under review by DECC

Our concern is that a VOLL cash-out would expose gas marketing activities to an unquantifiable price risk, should a GDE ever be declared. However, the low likelihood of such an event happening makes it uneconomic to take anticipated physical or financial mitigation measures to hedge against the exposure. We believe that shippers are more likely to take the risk than to pay to protect a highly unlikely event.

The implicit consequence of the above is that, should the risk of a GDE become material, all mitigation measures would be taken exclusively in the spot market. The prevailing view is that once a GDE becomes likely to be declared, most trading would aim at clearing exposures not backed up by physical gas. This because we expect that as National Grid runs out of all possible warning notices, economic incentives and obligations to attract more gas, the volatility of the trading environment could likely become unpredictable and the financial exposures with counterparties become unmanageable. This scenario could be exacerbated by the limited commercial interruptibility BP expects to be present in the GB gas system, which could lead to an abrupt start of firm load shedding once a GDE reaches stage 2.

More specifically BP considers that:

- The current market design would deliver all possible gas under all but the most extreme circumstances, which in any case are likely to be beyond shipper control. We consider this view largely applicable in spite of the flaws of the current emergency cash-out mechanism, as the experience during times peak demand showed that the already strong economic incentives would be reinforced by a strong reputational element to make available as much gas as possible into the market at competitive prices
- It is unlikely that the threat of a VOLL cash-out will bring additional natural gas in comparison to the one available under current market arrangements.
- As the likelihood of a VOLL cash-out becomes material, shippers would stop selling forward as the commercial risk of an operational failure or unplanned outage increases exponentially. Parts of physical gas supplies could remain unoffered to hedge against the risk of short positions or would be offered at VOLL (as this is the only price where a failure to deliver is fully hedged).

Hence, in light of the above considerations BP considers that industry would benefit from further reflection on alternatives including centralized DSR auction and further interventions. We think this decision could lead to devising a solution more in line with the current commercial practice, increasing the likelihood of an effective achievement of Ofgem reform goals while guaranteeing least distortion to the current GB market functioning.

<u>*Centralized DSR auction*</u>

BP considers that special merit should be given to the draft proposal on the centralized DSR auction which the Gas Forum (GF) recently brought forward. BP's support builds on the emerging consensus across the industry and Ofgem comments in the proposed decision document around the fact that Demand Side Response is likely to constitute one of the most cost-effective measures to build additional SoS into the GB gas market system. The proposal still requires significant developmental work, but there are some clear parallels between the purpose of the GF proposal and Ofgem proposed commercially interruptible contracts. Most importantly, achieving a centralized DSR auction would allow greater possibility of reducing the huge financial liabilities which VOLL is likely to generate.

About the Implementation arrangements

We think that one key issue with respect to the implementation arrangements is how to address the increased insolvency risk which would arise assuming that VOLL is in place.

One of the ideas we support positively is to use the DSR fund to prioritize payments to the DSR to pay long shippers with SAP, given that this measure alleviates insolvency risk and associated credit issues. Nonetheless we are doubtful about the embedded tension which VOLL produces between ensuring prompt payments to long shippers / compensating customers, and generating a pressure well beyond the financial capability of some short shippers. While under the current arrangements we considered acceptable on a "least evil solution" basis the transfer to neutrality of all missing payments, we think that the built-in risk of VOLL to generate unmanageable financial exposure would require some ring-fencing to avoid a domino effect.

Our greatest doubts are around:

- How solvent short shippers absorb VOLL liabilities of shippers which defaulted
- How missing payments could finally lead to clearing through neutrality and therefore paid by long shippers.

Specifically we suspect that the transfer of liabilities from defaulted shippers on remaining short shippers could create an insolvency "snowball" effect, increasing the risk that some of the less creditworthy short shippers could default too. As this domino effect could build up, there is an increasing risk that liabilities could finally be transferred to neutrality. This would mean that long and short shippers which nominated physical gas into the GB system would ultimately underwrite the missing payments.

Such a scenario could reduce the incentive to bring additional gas into the GB market during a GDE, therefore possibly working against Ofgem goal to ensure a prompt resolution of a GDE. We consider such outcome potentially detrimental for large players, as we expect that the tightened credit environment could lead to a scenario where big shippers are more likely to be capable to support purchases of significant volumes of additional gas at high prices. We therefore consider strategic that Ofgem assesses thoroughly that there should be appropriate incentives on large shippers to flow volume.

BP would therefore welcome Ofgem considering the consequence of VOLL on the neutrality arrangements as an additional weakness possibly reducing the ability of VOLL to deliver Ofgem goals. Should Ofgem conclude VOLL remains the most effective way forward, we suggest that Ofgem consider to ring-fence in some way at least the exposure of long shippers to insolvencies of defaulted short shippers. We think such measure would be strategically necessary to make sure that supply levels under the VOLL regime reach at least the supply levels we expect under the current regime.

Please feel free to contact us should you wish to discuss in more detail our concerns and views on the current Ofgem proposed decision.

Kind Regards,

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Regulatory Specialist