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Dear Anjli

Ofgem further consultation: Gas Security of Supply Significant Code Review – Proposed Final Decision

Members recognise that increasing reliance on international gas markets may expose the GB market to a higher risk of a Gas Deficit Emergency (GDE) and thanks Ofgem for the opportunity to respond to their Significant Code Review (SCR) proposal.

Background

Within the SCR Ofgem seeks;

- To minimise the likelihood of a GDE occurring by encouraging gas shippers and suppliers to undertake sufficient investment to enhance security of supply;
- Minimise the severity and duration of a GDE, if one ever occurred, by sharpening the incentives to attract gas into GB;
- Ensure that firm consumers are paid for any involuntary (Demand Side Response) DSR services they provide in an emergency.

In Ofgem's view the above can be achieved via a new cash-out pricing methodology to be implemented during a GDE. They propose that cash-out charges for shippers who have under delivered gas ("short shippers") during firm load shedding are set to Value of Lost Load (VoLL), which has been calculated as £20/therm. During the same period, shippers who over deliver gas ("long shippers") will be cashed-out at (System Average Price) SAP capped at VoLL.

Ofgem proposes that these charges will be treated as balancing charges and will be included in the monthly Energy Balancing Invoice (EBI). Credits and receipts resulting from those charges will be held within the neutrality bank account.

EBCC members note that Ofgem has not considered community credit arrangements within the SCR and that it does not believe that such arrangements are within the scope of their proposals.

<u>EBCC's Response</u>

Whilst the EBCC notes Ofgem's view that it is within the gift of the shipper community to ensure credit arrangements are suitably robust to meet increased risks, the nature of changes which may be required will ultimately have to be decided by Ofgem. One outcome of this process could be that Ofgem chooses to reject the industry’s attempts to change the credit regime. It is the EBCC's view that this SCR presents real and substantial issues which must be given due consideration. In particular the EBCC considers that there are key areas where significant impact to the energy balancing credit regime is expected should this proposal as outlined by the SCR proposed final decision be implemented. These are outlined below:

1 - Energy Balancing Security

Any shipper failures which take place during or shortly after a GDE will have serious effects on the community, which will incur not only the cost of the termination but also any sums payable by a short shipper and associated recovery costs.

The value of security which would be necessary to ensure the community is secured appropriately against failures with a potential cash out value of £20/therm is a matter of serious concern to the EBCC. At present shippers must provide a letter of credit or cash secured with a non-registerable deposit deed. The security calculation methodologies are designed to adequately cover potential failures on average system prices, at present the value of all energy balancing credit stands at £360 million.

In the event of a GDE in which £20/therm VoLL prices were applied, it is the belief of the EBCC that there would be a rapid escalation in security values in order to reflect a 30 fold increase in price. Based upon current rules this would equate to approximately £10.8 billion in security that the community would have to fund – a prohibitively excessive sum.

2 - Market Operator Security

In addition to finding the relevant funds for energy balancing purposes, shippers will also be exposed to the Market Operator security arrangements, which are calculated by reference to price and will therefore increase concurrently. This is likely to have the most immediate impact, as shippers unable to secure their trades will not be permitted to use the OCM trading platform or will have to dramatically reduce the volume of gas they trade. This may force shippers into a short position, having the potential to further compound the situation the SCR is attempting to address.

The EBCC is of the opinion that this may cause immediate shipper failures and therefore perpetuate a gas deficit emergency. As the community bears the costs of failure, it would be highly detrimental to the market.

3 - Entry to the GB Market

Having considered increased security arrangements, the EBCC believes that the necessary value of security will act as a barrier to entry for new shippers. Whilst this in part arises from the difficulty new entrants will encounter in providing the calculated value, it also stems from the very real problem of identifying sufficient financial institutions with appropriate credit ratings to issue such security. The current global economic climate has already resulted in the significant lowering of credit ratings of financial institutions within every sovereignty and the EBCC is of the opinion that this is unlikely to improve in the near future.

4 - Indebtedness Accruals

The EBCC has doubts that the current User Anticipated Balancing Indebtedness (ABI) accrual calculations outlined in UNC Section X2.5.1(c) would be fit for purpose in preventing a rapid spiral of indebtedness for short shippers during a GDE. It does not permit the use of more accurate and up to date data to prevent shippers accruing considerable imbalance debts in a short period of time, opening the community to increased risk. This is due to a timing delay in closed out data, which causes a ten day time lag before the impact of a price spike is included in a User's ABI

An attempt to modify Section X2.5.1(c) was proposed by the EBCC in 2009 but was rejected by Ofgem on the grounds that the power to calculate shippers' ABI using data in the public domain other than close out data would reduce transparency and increase uncertainty. The EBCC considers that implementation of the SCR as currently proposed may expose shippers to multimillion pound imbalance debts. These will be in considerable excess of their usual charges and it is therefore essential that the most up to date information can be used to manage their credit position and mitigate the volume and value of potential shipper defaults.

5 - Shipper Default and Failure

A further significant impact of Ofgem's proposed £20/therm cash-out charge is an increased risk of shippers failing due to non-payment of high value energy balancing invoices or associated notices. During 2005/06, when SAP reached £2/therm, the EBCC was required to make the decision to terminate two shippers who were forced into insolvency in order to protect the community from avoidable financial loss. If the £20/therm cash out prices were applied, the EBCC would expect this number to rise sharply resulting in the remaining shipping community bearing substantial costs for the debt and associated recovery costs.

Modelling of the VoLL price impact, based on previous historical price peaks and provided to Ofgem during the initial consultation stages, indicates that even where shippers are moderately short they will accrue substantially increased imbalance charges. Those charges raised indebtedness in short shippers by as much as 1000% based on 21 December 2010 (a Gas Balancing Alert day) data, which resulted in the number of shippers in cash call positions increasing by 100%. In the face of cash calls, further security requests and energy balancing invoices calculated on inflated cash out charges, the EBCC expects that a number of shippers would be at a greater risk of failure.

The EBCC is particularly concerned about the impact on smaller shippers, who may not have the cash flow necessary when facing inflated cash-out charges. They are therefore poorly placed to weather a GDE under the SCR proposals. Members believe it is likely that smaller shippers will fail first during a GDE and failures may thereafter spread rapidly within the community.

Finally we note from Ofgem's Impact Assessment (page28, figure2) that Ofgem anticipates financial exposures across the industry running into hundreds of millions of pounds. We do not believe that the implications of losses on this scale have been properly factored into the design of the SCR proposal.

6 - Neutrality Bank Account

In addition to the projected impact to the community regarding failures and security, the practical implications of the neutrality bank account must also be considered. Overdraft and transactional services are purchased for the neutrality bank account and funded by the community. Currently these services permit processing payments up to £50 million within day and an overdraft of £10 million. Both of these limits are likely to be unduly restrictive when processing energy balancing invoices for £20/therm cash out charges.

In particular, we note that during historical price spikes where SAP reached £2/therm, overdraft facilities required extension beyond £10 million and the account balance swung rapidly in and out of credit in excess of £30 million. It is the EBCC's opinion that in order to make the necessary payments to long shippers and firm customers, who have provided involuntary DSR in accordance with the SCR principles, a significant increase to current service values would be necessary. This represents an additional cost to the community and would require breaching the permitted aggregate limits specified by the Energy Balancing Credit Rules for exposure to financial institutions.

Furthermore the Committee would question whether National Grid or the financial institution providing neutrality banking services would have the appetite to underwrite the necessary level of exposure. The placement of the DSR pot within the neutrality account may be viewed as particularly exposing those parties to risk, which might be considered unacceptable.

7 - Funding

The EBCC considers that the recovery of VoLL cash-out charges is integral to the function of Ofgem's proposals, as the monies received from short shippers will be used to pay long shippers and form a DSR pot for firm consumer compensatory payments. If the DSR pot holds insufficient funds then a charge proportional to a short shipper's under-delivery will be levied and, if the recovery is not enough, the community will bear the remaining cost via neutrality.

This methodology raises two concerns; the first is the assumption that payments from short shippers will be sufficient to fund all or a substantial part of the credits due to long shippers and firm customers. The second is that it does not consider the impact of short shipper failures.

It is impossible to predict precisely how the market will behave in the case of a GDE, but it can be the case that long shippers outweigh the volume of short shippers on any day. Even where those figures offset one another, there is still no provision for DSR compensatory credits to firm customers.

The EBCC recognises that the secondary charge to short shippers aims to address such shortfalls. However in order to protect short shippers Ofgem's proposal allows for situations where the recovery is proportional to their under delivery, which has the potential to permit substantial underfunding. Members therefore question whether this charge would sufficiently top up any shortfall to prevent neutrality bearing a majority of the cost.

Additionally, in the case that any of the short shippers default on payment and are terminated, it is specified that normal credit procedures apply. Current processes would dictate that the debt is recovered from neutrality two months after the due date and the cost smeared to live shippers. The EBCC would therefore conclude that a significant proportion of credit payments due under Ofgem's proposals may be financed via a neutrality smear and therefore at an increased cost to shippers regardless of their position during a GDE. This has the potential to perversely impact shippers who have the greatest throughput, possibly dampening the incentive to over deliver.

8 - Invoicing Systems

The EBCC is of the view that there is no capability within current EBI systems to target charges against short shippers, as required to invoice additional levied charges. There is also no capability to make adjustments to the exposure monitoring systems to adjust charges for ongoing DSR claims. To include these items substantial system changes would be necessary at cost to the community.

9 - EBCC Function

Ofgem has placed significant emphasis on the responsibility of the shipper community to manage the credit implications of the SCR, which in its opinion ultimately lies with the EBCC. It is therefore vital that the position and liability of the members is subject to appropriate scrutiny. It should be noted that the EBCC membership is not currently at full capacity and members are employees of shippers, who may be affected parties in the event of a GDE.

EBCC members currently abstain from voting where their company holds an interest in the concerned party in default proceedings. In conjunction with reduced membership, this presents the possibility that during a GDE, or in the immediate aftermath, there will be insufficient voting members to make quorate decisions. The possibility increases with the volume of shippers in default as the scope of members interests within the community is substantial. As a result the Committee is extremely concerned that the potential volume of shippers entering default positions may effectively render the EBCC inoperable. The alternative is to place members in the position where they make decisions which may be challenged as not in good faith, creating personal liability for losses. Neither position is viewed as tenable and is considered to be highly detrimental to the market.

10 - Supplier Failure

Whilst unlikely to occur in the immediate aftermath of a GDE, the EBCC considers that the proposals under the SCR may ultimately place the GB market at risk of a major shipper/supplier failure. A large part of all credit processes focus around recovery from neutrality smears, as these are based on throughput and it will always be the case that the largest market participants bear a majority of those charges.

Whilst Members recognise that these parties may be best placed to absorb additional costs in the normal course of market activities, artificially high charges and the multiple failures which may arise following a GDE expose the largest shipper/suppliers to unprecedented challenges in cash flow. It must therefore be considered that one or more may enter insolvency proceedings, with the result that they will be terminated and Supplier of Last Resort (SoLR) processes commenced. This is of particular concern due to the likelihood that SoLR processes will not be fit to function with the volume of supplies.

This problem has been recognised by Ofgem and DECC, and a proposal made for Special Administration Orders permitting the Secretary of State to fund an insolvent supplier. The EBCC members have reviewed the business rules associated with this process as published by DECC and believe it would fail to prevent the termination of the supplier due to the insolvency requirements. It therefore represents no improvement to current SoLR processes and leaves the community and customers exposed.

Conclusion

The EBCC recognises that Ofgem wants to make incremental changes in order to help improve security of supply within the GB market. However the EBCC's view is that the methodology as proposed exposes the community to significantly increased costs and untenable risk of failure. Whilst Ofgem has stated that it is not its intention to substantially amend the SCR proposal, the EBCC believes that there is compelling new evidence in the impact to the credit regime which has not been given due consideration and has not been factored in to Ofgem's Impact Assessment, but should have been.