

Gas Security of Supply Significant Code Review – Proposed Final Decision

Consultation Response

Energy UK welcomes the opportunity to comment on Ofgem’s proposed final decision. We are however disappointed that Ofgem’s final decision is little changed from its draft decision despite strong reservations being expressed by industry. Furthermore the decision seems to have been taken without full consideration of the interaction between gas and electricity markets as was called for in responses to the draft policy decision by a number of respondents, beyond those with generating interests, including; National Grid, Chemical Industries Association and Consumer Focus. We believe these interactions could lead to a situation where the gas National Emergency Controller or even Secretary of State effectively determines which CCGT plant face capacity mechanism penalties and which do not. We now call on Ofgem to reconsider its implementation timetable to allow for a more detailed and transparent appraisal of the interactions between markets and more holistic assessment of these proposals, any further interventions and industry led alternative proposals.

We continue to believe that the current proposals are unlikely to deliver additional physical supply security to GB or reduce the likelihood of a gas deficit emergency occurring, which is a primary objective of reform. However we consider that alternatives, including demand side reduction (DSR) contracts, have the potential to enhance supply security, but only in the absence of a £20/therm cashout target. We believe that a National Grid led contracting process for a defined volume of demand side reduction to take effect once an emergency is imminent has merits for the following reasons:

- A measurable physical response will be delivered, many relevant sites have telemetry
- Confidence in a pre-determined volume being delivered
- Potential to avoid an emergency being declared, the response can be delivered just prior to an emergency if linked to ‘alerts’
- Independence of National Grid, separate from the customer – supplier relationship
- DSR price discovery will be determined by the market for such services
- DSR prices can be reflected into cashout, providing proportionate incentives on shippers to balance

We therefore urge Ofgem not to use its Gas Act powers to direct detailed changes to the UNC and to allow for further development of Centrica’s UNC Modification Proposal 0435 ‘*Arrangements to better secure firm gas supplies for GB customers*’ and to provide for a full transparent assessment of this proposal against the SCR proposals and existing arrangements.

Below we highlight our key concerns with the proposed final decision

Key Concerns

Market impact of £20 therm cashout and compensation

Energy UK has particular concerns regarding the impact on the market of the arbitrary £20/therm cashout set when firm load shedding is required and this level of compensation being paid to customers irrespective of payments received from short shippers.

Whilst we acknowledge that a gas deficit emergency is a low probability event and that industry will take all reasonable steps to avoid one occurring we believe it is important that the market is allowed to operate without distortions for as long as possible. We do not believe that setting cashout to £20/therm will

facilitate this; rather it will set a target price for trading when an emergency seems imminent. This in turn will deplete credit lines and liquidity will diminish, which may limit additional gas being directed to GB. This could in itself bring forward the declaration of an emergency so that the NEC can direct maximisation of supplies where it has powers to do so. We do not understand why energy balancing credit issues have not been considered as part of this SCR, particularly since the idea of a significant code review was to address large, complex issues that may not progress well through normal code modification processes.

A further area for concern is the likelihood of suppliers exiting the market if they are found to be short in an emergency situation. The issue is that any payments these parties are unable to make will ultimately be socialised across all shippers based on physical gas throughput. This may lead to further bankruptcies. It seems totally inappropriate that parties that have made prudent provision to supply their customers (or help the emergency situation by bringing more gas to GB) should face penalties that may be large and unpredictable. In any incentive framework it is only appropriate to incentivise parties to adjust behaviour and achieve outcomes where they have some control or influence over the processes that achieve that. In this case shippers / suppliers cannot influence the behaviour of other parties, and are vulnerable to *force majeure* clauses in physical supply contracts, a further issue that Ofgem seems unwilling to explore.

We consider that where compensation is to be paid to customers that this should be limited to the amount that is recoverable from short shippers, without socialisation to the remaining active shippers of any costs not paid by short shippers, should they fail. This would provide some degree of protection to parties that have made adequate provision to secure physical gas supplies for their customers. It is vitally important that any financial incentives take ample account of the physical realities of gas supplies, particularly at times of system stress. The gas market is not a pure commodity market.

Interactions between gas and electricity markets

It is rather surprising and very unsatisfactory that Ofgem, as regulator of both gas and electricity markets, is not taking a more holistic view of the interactions between these markets particularly at times of system stress. Even under the current arrangements CCGT running decisions are the key point of interaction between the markets, but in the future such running decisions are likely to become more complex as multiple incentives and penalties seem likely to apply:

- ▶ Gas emergency cashout
- ▶ Compensation if firm load shed
- ▶ Capacity mechanism penalties
- ▶ Electricity cashout

However despite the pivotal importance of CCGT running decisions to both markets, interactions between the two markets do not seem to have been considered in any real detail, despite a significant number of respondents raising this in their responses to the draft policy decision. Ofgem simply notes at paragraph 2.8 of the proposed final decision that it is closely monitoring development of the capacity mechanism as part of Electricity Market Reform, due to the potential role of gas-fired generation in any capacity mechanism. Given that firm decisions about the capacity mechanism and in particular the penalty regime will not be taken until after Ofgem makes its final SCR decision and potentially issues directions to implement (at least according to the current timetable) it is vitally important that Ofgem identifies how firm decisions about the capacity mechanism will be further considered in this context, and communicates this to industry. This should include what the process and timescale will be. We consider that the capacity mechanism framework may well constitute material new information that may lead to a review of the policy decision. We consider this gives further weight to reviewing the timetable to both allow for development of UNC Modification Proposal 0435 and for there to be additional clarity on the detail of the capacity mechanism penalty framework.

Whilst it is not appropriate to try and pre-judge DECC's decision on the capacity mechanism, it seems as though a delivered energy model may be favoured. If this is linked with high penalties, potentially higher than gas cashout / compensation, CCGTs will face strong and potentially conflicting incentives, when both markets are stressed simultaneously: A scenario which would seem increasingly likely in the future, as gas plant replaces coal plant as part of the de-carbonisation agenda. Electricity capacity mechanism penalties will encourage running at the contracted level, whilst penal gas cashout prices will encourage the same plant to voluntarily turn off in an orderly manner to reduce stress on the gas system.

If CCGTs continue to generate then this will precipitate the declaration of a gas deficit emergency so that the NEC can instruct the plant to stop taking gas to ensure the continued safe operation of the network. In such circumstances the NEC (or potentially the Secretary of State, if the Fuel Security Code is invoked) will effectively determine which plant face capacity mechanism penalties and which do not. We are not convinced that this is reasonable and proportionate, and think the incentives need to be better aligned to deliver the best outcome for securing physical energy supplies for GB; or risk commercial penalties driving potentially distorted market participant behaviour in an emergency.

Comments on the impact assessment

Between the draft and final decision documents the Redpoint modelling was amended to assume that CCGTs will be firm load shed before other daily-metered (DM) customers in an emergency as this is consistent with the “largest off first” principle which is utilised by the NEC to ensure the safety of the system. This assumption still holds.

Ofgem’s impact assessment also states at paragraph 3.85:

“In all but the most sudden emergencies we would expect a significant reduction in demand from gas-fired electricity generators ahead of an emergency in response to the increasing wholesale price as a result of tight supply/demand margins.”

This may occur to an extent if there is spare non-gas fired capacity available, but it may be limited if electricity prices keep pace with rising gas prices and clearly will be influenced by the capacity mechanism penalties. We believe the final point here challenges the key assumptions underpinning the impact assessment such that much more significant volumes of CCGT gas load may need to be load shed in an emergency than has been modelled. This currently stands at 2.4M therms of gas, as presented in table 4, when the actual volume generating prior to firm load shedding could be at least 10 times higher than this. The cost of this volume at £20/therm would be considerable and should be taken into account in determining the cost to customers of these proposed reforms.

A further complexity is that some shippers may agree notional interruptible contracts with their own CCGTs which will mean they forgo £20/therm compensation but retain gas within their portfolio to manage the risk of a short position or to maintain supplies to domestic customers. We would not envisage this enhancing security of supply as we would still consider it likely that interruption would not occur prior to load shedding by the NEC. However these interruptible contracts may not be secured as parties may prefer to receive the £20/therm compensation once load shedding occurs as this would go some way towards offsetting the capacity mechanism penalties.

We also note that the impact assessment is based on the Gone Green scenario. We would like to see a justification of why this was the only demand scenario chosen, as this may not be the most likely outcome, and we consider that other scenarios should also be analysed, to provide a more balanced understanding of the range of cost benefit outcomes.

Security of supply standard

We remain concerned that Ofgem has still not defined what level of security of supply is required. There are many references to a 7 day outage occurring once in 20 years, a standard quoted in the EU Security of Supply Regulation 994/2010 and this is used as the basis for the domestic VOLL calculation. But the DECC risk assessment for the Regulation reports that the UK meets the supply and infrastructure standards by some margin. This is also confirmed by the Redpoint analysis carried out on behalf of Ofgem, which shows a Non-Daily Metered (NDM) supply failure probability of only 1-in-167 years. Hence it remains unclear what level of security Ofgem wishes there to be.

Now that the proposals have been more fully defined it is clear that they establish an enabling framework rather than actually delivering security of supply *per se*. Any improvement in security of supply will only be achieved if there is a change of behaviour by market participants and this is not inevitable given the low probability of a gas deficit emergency occurring. In any event, participants may seek financial protection from penalties rather than securing physical gas supplies since the latter leaves parties open to *force majeure* risk.

The impact assessment also identifies that any improvement in security of supply is only for firm daily metered (DM) customers which is only achieved by some DM customers entering into commercial interruption agreements such that they will be called off prior to firm load shedding of other DM customers. NDM / domestic customers do not see any improvement in security of supply, as this remains at a 1 in 167 years risk of interruption under 'do nothing' and options 1 and 2. Therefore the current proposals are ineffective in enhancing domestic security of supply and given the unintended consequences alternative solutions should be considered.

There has been much debate over whether DM customers will enter into commercial interruptible contracts, given the tension over potential shipper discounts and DM customers' wish to continue with business as usual or receive a £20/therm payout if they are firm load shed. The impact assessment assumes that 27mcm out of a possible 36.6 mcm of DM load (74%), agrees such contracts. We consider this very optimistic and wonder if it is based on evidence from DM customers and whether there could be a price mismatch between what customers might expect and what suppliers are prepared to offer. A simple breakeven analysis of discounts, calculated from a payment of £20 therm for 7 days once in 20 years is equivalent to a discount of 2p/therm on every unit of gas across that period. But given that the probability of this occurring (even in Ofgem's own analysis) is lower than once in 20 years then there will be tensions between what suppliers are willing to offer and what customers are prepared to accept.

In summary, Energy UK still has deep concerns about the Ofgem proposals delivering enhanced security of supply to gas customers, given the impact on the market of the proposals, an inadequate assessment of the interactions with the electricity market and the absence of any desired level of supply security being articulated. We firmly believe that Ofgem should take some time to further consider these issues and allow for further development of industry led proposals such that a more transparent and holistic assessment can be made of arrangements which may better deliver physical energy security to GB gas and electricity customers. If you would like to discuss this further do not hesitate to contact me, details below.

Note: This response represents a broad consensus of members' views, and we would point out that National Grid was not a contributor to this response.

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