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Gas Security of Supply Significant Code Review – Proposed Final Policy Decision

Gas Forum response

Introduction

The Gas Forum recognises that Ofgem has requested that respondents focus on the associated business rules and licence changes presented alongside the Decision Document, however, given our continued opposition to the proposed package we are compelled to set out our objections to its implementation.

The Gas Forum responded to the draft policy decision in January 2012 and in common with the significant majority of respondents detailed numerous economic, practical and ideological differences to those set out by Ofgem. In good faith and in response to our request, we assumed that following Ofgem's letter of 24th February that a Final Decision would not be taken until a full and proper consideration of the wider gas security of supply position had been undertaken. Reasonably, we understood this to mean that the work Ofgem had been asked to carry out by DECC on "further intervention measures" would be included in this wider review. We now understand this to be partially correct.

Ofgem has submitted its report to DECC, however, the assumption underpinning the wider analysis carried out to assess the need for "additional measures" is that the SCR proposal, as set out in the Final Decision, will be implemented. In our opinion, this is unacceptable as a) it assumes that the SCR proposals are both necessary and workable, and b) the wider analysis is opaque to the industry.

Notwithstanding our opposition to the SCR proposal and concerns with the decision making process, the Gas Forum members attended the workshops hosted by Ofgem. It would be fair to state that the workshops served to identify a host of issues with the SCR proposal, both in terms of practical implementation and additional unintended consequences.

In response to our fundamental opposition to the SCR proposals and the subsequent identification of additional problems through the workshop process, the Gas Forum presented alternative models for consideration by Ofgem. These proposals were developed with the assistance of the MEUC, Energy UK and Oil & Gas UK. More recently, British Gas has raised a formal modification to the UNC (0435) which includes a number of principles advocated in the Gas Forum models. As a result, the Gas Forum supports a number of the elements set out in the Modification Proposal and in short, believes it would be significantly more effective in practice than the Ofgem SCR proposal when tested against the original SCR objectives.

The Gas Forum is considering its position with regards further development of the models it presented to Ofgem, however at this stage it will lend its support to the development of UNC Modification 0435 business rules. We believe that given the weight of opposition to the SCR proposal Ofgem must permit the British Gas proposal to be fully "worked up" alongside other potential alternative solutions, prior to it taking any full and final decisions on changes to the current regime.

Finally, as discussed with members of the Ofgem SCR team, we have provided answers to the questions produced by Ofgem following the presentation of our alternative models; these are contained in the Annex to this response.

<u>Restatement of reasons for our opposition to the SCR proposals</u>

Below, we restate the key points provided in our response in January 2012 to the draft proposals consultation exercise. We have augmented these points with additional observations which have come to light during the course of the workshops hosted by Ofgem in recent months. The additional points are highlighted in bold for ease of reference.

Cash-out reform and VoLL

The Gas Forum is unconvinced that the proposed changes to cash-out and the introduction of a VoLL compensation scheme will assist in the fulfilment of the main objectives for the following reasons:

- It is assumed that shippers will be able to respond to the price signals in all cases. In some cases this maybe the case, but in others not, depending on; the "speed" of the emergency; the availability of alternative supplies and/or DSR; and credit lines available to shippers etc… **Such insurance will not come for free, but Ofgem have not factored any such cost estimate into their IA. (The same applies to any other mitigation measure.)**

- A cash-out cap may lead to a more rapid escalation of prices, towards the cap**. The existence of an administered cash-out price in the market will distort market behaviour.**

- It is assumed that shippers will seek to insure against low probability, high cost events. This may be the case in some instances, but not all. **For such events, the risk is typically managed more effectively when it is shared.**

- **The number of customers which will qualify for DSR is limited by the xoserve central systems to DM customers. Due to the NDM ECQ process there is no benefit to shippers entering into DSR contracts with NDM customers, even though daily read**

equipment is fitted at the offtake. This has the effect of reducing the pool of customers available to shippers to transact for DSR.

- **The risks to individual shippers are unquantifiable and unequally applied. For a shipper with limited, or no access to DSR qualifying customers i.e. DM customers, it is unable to mitigate against imbalance risk via DSR contracting. It is understood by the industry and Ofgem, that the SCR proposals will not provide sufficient incentive, or certainty to underwrite investment in infrastructure projects, such as gas storage. The upshot is that under Ofgem's SCR proposals, shippers are very limited in their ability to enter into arrangements which protect against imbalance risk up to, or during an emergency.**

- Ofgem assumes that in the event that the market does elect to "insure" against a GDE it will do on the basis of, primarily, DSR contracts. The Gas Forum is concerned that sufficient DSR volumes may not be available; strike prices will tend towards the domestic VoLL and be unattractive to shippers; and customers will not want to enter into multiple year contracts with shippers. Contracting on this basis would inhibit their ability to "switch" suppliers.

- **If, as we believe, the amount of DSR will not be sufficient to hedge shippers' exposures, then the costs of other mitigation measures and/or the impact of higher wholesale prices on remaining unhedged positions would be likely to feed through, sooner or later, into consumer prices. Again these costs have not been analysed by Ofgem through its Impact Analysis, which we believe to be a significant flaw in this process.**

- **We have anecdotal evidence that there is a general reluctance among customers to enter into DSR contracts with shippers. We understand that in response to Ofgem's request for greater clarity on this issue the MEUC has recently published a survey which will go out to a large number of DSR qualifying customers. We await the findings of this survey to confirm if the evidence collected by our members, on a bilateral basis reflects more widely held customer views.**

- The levels of cash-out and compensation will lead to rapid escalation of shipper debt and credit erosion. Rather than reducing the likelihood of a GDE occurring, the mechanism may simply lead to shipper insolvency and market malfunction. **The lack of detailed consideration by Ofgem of balancing credit issues is of significant concern to our members.**

- **The basis upon which the targeting of monies for the payment of involuntary DSR events is fundamentally flawed. In the event that the monies recovered from short shippers are insufficient to fund such DSR payments, then it is our understanding that additional funds will be acquired via standard neutrality mechanisms. Given that neutrality shares are based on actual shipper flows, this creates a disincentive on shippers to deliver incremental supplies to the GB market up to or during an emergency. Not only will shippers, who are directly impacted by an event outside of their control (which may have directly contributed to a GDE occurring in the first place) be unable to take actions to "correct" their imbalance position, they, and indeed others, may well be perversely deterred from bringing more gas to GB.**

This outcome runs contrary to the central objectives for change of reducing the likelihood of a GDE occurring and reducing the impact should one occur.

Concluding remarks

The Gas Forum is strongly opposed to the SCR Proposals set out by Ofgem. We believed prior to the publication of the Final Decision that the proposals were fundamentally flawed and after further deliberation during the Ofgem workshop process, are convinced that additional shortcomings have now been identified which make them unworkable.

In addition, a significant number of respondents from all corners of the industry (including customer representatives) have raised numerous issues with the proposals and we do not believe that Ofgem has given the issues raised proper consideration.

On this basis, we recommend that Ofgem halts any moves to implement the SCR Proposals and permits the British Gas UNC Modification Proposal (and possibly alternative proposals) to be afforded sufficient time to be developed, before considering the most appropriate way forward.

Yours sincerely

David Cox – Managing Director

Richard Fairholme – Chairman, Transmission Shipper Workgroup

Annex – Response to Ofgem questions.

Q1 - For what reasons do you consider that a centrally co-ordinated approach is preferable to bilateral contracting by individual shippers/consumers. Please outline your rationale for this.

It is our understanding that customers are more comfortable contracting with the SO for system operation reasons only rather than risk price optimisation by a shipper. We await the results from the MEUC survey for confirmation of this view.

On an economic level we believe that central contracting will result in the achievement of a more economically efficient outcome, as:

- We wish to make it clear that centrally co-ordinated DSR should not be considered in isolation. The overriding concern of our members is the imposition of an administered £20/th VoLL and cash-out price. We do not believe that simply replacing shipper DSR contracting with central co-ordination would bring such benefits as to alleviate the problems associated with administered VoLL.
- The pool of customers "available" to NGG (in the event that they are the central contractor) would be greater than to any single shipper. This will mean in the first instance that the tender process will be more competitive and more likely to achieve lowest prices, which is Ofgem's stated ambition for Operating Margins.
- A centrally co-ordinated approach would be more straightforward and cheaper to manage, resulting in reduced administration and transaction fees and ultimately lower costs to consumers.
- In a competitive market, Shippers will naturally take different views on the likelihood of an emergency occurring and the exposure of their business to this risk. Because of this there will be an inefficient tendency for over/under contracting on an individual basis.
- Contracted DSR ensures a physical response to a GDE rather than purely a financial one.
- The payments made by NGG to customers would effectively be underwritten by the entire industry. Again this will bring down costs associated with for example, individual credit positions.

Q2 - How would the proposal interact with bilateral commercial interruptible contracts?

- We do not believe there are interaction issues. Bilateral arrangements, for commercial optimisation exist now and we would expect them to continue even under the Ofgem SCR regime.
- Bilateral contracts can co-exist with centrally co-ordinated contracts as they did in the early days of Code with Shipper Nominated Interruption and Transco Nominated Interruption.
- By way of example as to how it might work, in the event that a customer had contracted with both a shipper and NGG, then in the event that NGG interrupts the customer under its contract (following for example the trigger of a GBA) then the

interruption would be “owned” by NGG and the shipper would forgo its DSR rights. The effect would be that the ECQ process would reflect the shipper’s inactivity.

Q3 - We are unclear as to how DSR payments, for those not eligible for the DSR auction, would be calculated. We understand the suggestion of a Panel setting an administered price, but the alternative option of a completely unfrozen price is not clear, when would a value be chosen? Isn’t there a risk that it could be extremely high and/or affected by a few very small trades?

- We understand that this area needs more work and the suggestions put forward by the Gas Forum were straw-men, however, we believe a number of options could be pursued and safeguards adopted.
- For example, a weighted average price of trades could be taken; a top 80% of trades by volume (aka the PEC process) could apply; minimum single trade volume could be used.
- Alternatively, limitations could be placed on the level of pay-out, for example capped at the total revenue raised from the cash-out of short shippers. This would overcome the problem highlighted in the main body of the letter concerning the disincentive to supply gas due to exposure to neutrality costs.
- Finally, it should be recognised that NGG will/shall only take volumes which will have a positive impact on the GDE. This should remove the possibility for opportunism and in any case Competition Law/Licence obligations should reduce potential for abuse.

Q4. We would appreciate more information on how a completely unfrozen cash-out price could work. What measures could be used to mitigate the risks of ‘extreme’ cash-out prices set by small volumes of trades? What would be the role of the SO, and could there be conflicts with the NEC’s powers to direct flows from stage 2 of a GDE?

- See points raised in the previous question in relation to potentially limiting extreme prices
- As a general principle, however, it is understood that the cash-out price may outturn higher than £20/th, but it would be appropriate in the event that it reduced the potential of a GDE occurring or limited its duration. This should be considered in the global context in which the GB market operates; i.e. the market should set a price which attracts additional supplies to the UK, as opposed to alterative destinations.
- As far as the last question is concerned, we understand that this is not clear cut and certain provisions would need to be developed to ensure there is no overlap between the SO and the NEC, particularly as the NEC could effectively take actions which could run contrary to commercial principles, such as accepting supplies which would be out of price order.

Q5. What role do you envisage an advisory panel could have in setting the cash-out price? How would you see this working and what factors do you think the panel would take into account in determining the appropriate cash-out price?

- We need to be clear that the advisory panel is just one option proposed, we understand that further work would need to be undertaken to develop it, however, there is precedent under the BSC.

Q6. Would money-in always equal money-out under the proposals, or could a shortfall arise under some circumstances? How could this be dealt with?

- Possibly yes, if for example compensation payments were to be capped at the amount of money in.
- We believe that the problem in this instance is no worse; in fact it is an improvement on that which exists under the Ofgem proposal for reasons stated in the main body of the response.

Q7. How do you envisage payments working their way through to consumers under the proposals, and what do you expect the timescales would be? If targeting costs at short shippers and using the cash-out mechanism, could there be risks created by non-payment, and could this lead to delays in payments to consumers?

- We appreciate that more work would need to be undertaken in this area, but the same problem exists under the Ofgem proposal.
- Alternatives might include a) NGG providing a central service for payment to customers, with recovery of those monies via the cash-out fund and additional recovery mechanism where needed, b) setting a fixed payment for customer types rather than a p/th rate.