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**Gas Security of Supply Significant Code Review – Proposed Final Decision**
**Gas Security of Supply Significant Code Review – Impact Assessment for the Proposed Final Decision**
**July 2012**

Dear Anjli

Thank you for the opportunity to comment on these consultations. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

The Gas Security of Supply Significant Code Review (Gas SCR) Proposed Final Decision sets out Ofgem's policy reforms for the emergency cash-out arrangements. In a Gas Deficit Emergency (GDE) cash-out for short shippers will be set at £20 per therm and the costs of firm customer curtailments will be treated as a balancing action and priced into cash-out with firm consumers that are disconnected being compensated at £20 per therm. Ofgem expects that setting the emergency cash-out price at an estimate of domestic VOLL will provide a strong incentive for shippers to arrange interruptible contracts with industrial and commercial customers. The emergence of this market underpins Ofgem's quantitative and qualitative assessment that their policy will enhance security of supply, as they acknowledge that investing in new short range storage facilities would be uneconomic for a risk neutral shipper[1]. Clearly, should this market not develop as assumed and we have strong reservations that it will not, then the policy may not deliver enhanced security of supply.

Below, we restate our main concerns with the policy as set out in the Proposed Final Decision, give our views on implementation and draw some key conclusions.

**Proposed Final Decision / Impact Assessment for the Proposed Final Decision**

We would support improving the signals that come from cash-out by introducing the risk of VOLL for short shippers into the arrangements. This should be through a *last resort mechanism* within the scope of the present market arrangements that would only be used in defined circumstances once all other market-led solutions to prevent a GDE had been exhausted. Sharpening price signals with the risk of VOLL would provide incentives that could deliver further investment in both demand and supply side solutions to

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[1] Gas Security of Supply Significant Code Review – Impact Assessment paragraph 3.15

improve security of supply. However, having increased the risk on shippers, they need to be able to mitigate it economically. We believe that the proposal for administered compensation for involuntary demand-side response (DSR) at VOLL seriously undermines shippers' ability to arrange commercially interruptible contracts.

Consequently, we strongly disagree that the market design should include compensation for involuntary DSR on the basis of an administered VOLL. This approach not only introduces significant financial risks but, more importantly, will result in an outcome that is unlikely to deliver Ofgem's policy intent. Shippers and customers have raised serious doubt about the assumed incentives created by VOLL compensation in stimulating a growth in commercial interruption contracts. The widely-held industry view is that most DM customers that could provide DSR will either seek contracts at £20 per therm or simply wait and receive VOLL under the compensation scheme. The £20 per therm compensation reduces incentives for customers to contract ahead and the default should be no compensation. This should lead to contracts being struck for a variety of durations and different timescales, including those that may be triggered following a Gas Deficit Warning. This would allow efficient price discovery rather than price being set by an administered VOLL.

Introducing £20 per therm compensation will increase the level of financial risk from sourcing additional gas as the market trades up towards VOLL or having a short position cashed-out. The policy to fund all involuntary DSR compensation payments irrespective of monies recovered from short shippers is seriously flawed. Recovering any shortfall via neutrality is perverse as the throughput-based charge penalises balanced shippers and reduces incentives to over-deliver gas that helps to resolve a GDE. Under Ofgem's proposals, a shipper's exposure under the GDE may be outside its own control and will be uncertain depending on the level of shipper payment default. Our concern is that this uncertainty creates a risk of contagion in the market and a domino effect as shipper default increases the costs recovered through neutrality which in turn may lead to further shipper default. We cannot believe that this is the intent of Ofgem's policy and therefore this element needs to be reconsidered.

We remain to be convinced that gas and electricity market interactions have been fully considered. Gas-fired generation is the largest provider of flexibility to the gas system and will become increasingly important to the electricity system over the period to 2020 and beyond, both for delivering replacement capacity for that closed under LCPD and IED and to provide back-up to increasing intermittent generation that is expected to connect. Decisions on EMR and capacity mechanism design are not yet finalised and the incentives created on CCGTs under the two regimes need to be properly understood.

It is unclear what new security of supply standard Ofgem is seeking to deliver under these proposals. The new standard is apparently set by the actions taken by individual shippers. However, the Impact Assessment confirms that the policy delivers no additional security of supply benefit for firm NDM customers, although the quantity of unserved energy for them is reduced. Given this, it seems disingenuous then to calculate the average cost of the policy reforms by including the NDM meter points. Any security of supply improvement is focused on the DM sector and is predicated on the assumption that the majority of DM customers sign "commercial" interruption contracts presumably at prices less than £20 per therm. Given the guarantee of payments at £20 per therm and the high risk/low frequency of any interruption events at this price we would question whether any new interruption contract would be signed since the "opportunity cost" of interruption is £20 per therm for customers. Should this lead to insufficient DSR contracted for individual shippers or in aggregate then the cost of covering the unhedged positions(s) will quickly spiral to £20 per therm. These costs, together with those for potential other mitigation measures and costs of credit are excluded from the Impact Assessment. Therefore, we conclude that the policy delivers no significant security of supply improvements and the costs of the policy are likely to be understated.

**Implementation Issues**

Ofgem has confirmed that it intends to use its Gas Act powers to direct the necessary changes to the UNC. It argues that this will expedite the necessary industry changes and provide certainty to the industry. DECC's security of supply analysis [2] notes that *"in the short to medium term, the UK gas supply infrastructure is resilient to all but the most unlikely combinations of severe infrastructure and supply shocks"*. This suggests that there is sufficient time to develop and implement the most efficient and cost effective solution. Furthermore, the series of workshops held by Ofgem develop the business rules, UNC and licence changes required to implement its policy proposals workshops have highlighted a number of complex implementation issues, many of which remain unresolved. In light of this, we do not believe that an October 2013 implementation is required or practical.

Our strong preference would be that a solution is developed under standard UNC governance processes. This will allow development of alternatives that meet the Gas SCR principles and that can be considered against Ofgem's proposals. This was the Ofgem's approach for the Project TransmiT SCR where a direction to National Grid Electricity Transmission plc (NGET) to raise an amendment proposal under the Connection and Use of System Code (CUSC) was given following conclusion of the SCR. We see no reason why the gas SCR should be treated differently and would welcome Ofgem's views. In any case, given the nature of Ofgem's Proposed Final Decision, we believe that there is a strong case for robust transitional measures such that companies can incorporate changes into their business plans. Industry recognised the requirements for transitional arrangements both in Project TransmiT and in the Final CUSC Modification Report for CMP201: *Removal of BSUoS Charges from Generation*. Contracting arrangements for industrial and commercial consumers normally occur in contracting 'rounds' and the implementation date needs to reflect this. Furthermore, shippers and suppliers will need to update their forward hedging strategies and incorporate any additional costs into tariffs.

**Conclusions**

- Our priority would be to improve the signals that come from the present cash out arrangements with a minimum level of further market intervention. The demand-side is important, but it should be a matter for customers and shippers to determine the value of providing the services, possibly alongside a last resort mechanism;
- Automatic compensation at VOLL for involuntary DSR should not be included. The fundamental assumption that it will create incentives for customers to sign commercial interruption contracts with shippers is incorrect and will only create additional financial risk;
- Implementation should be through standard UNC governance which will allow alternatives to be considered, allow development of workable business rules and permit full consideration of wider industry policy initiatives including Electricity Market Reform and gas security of supply further interventions; and
- A lead time of at least 2 years is required so that Shippers and Suppliers can reflect any new arrangements in their forward contracting strategies.

We hope these views are helpful and if you wish to discuss any aspect of them in further detail, please do not hesitate to contact me.

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

[2] Risk Assessment for the purpose of EU Regulation 994/2010 on security of gas supply, November 2011