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Dear Anjali,

Gas Security of Supply Significant Code Review – Proposed Final Decision

Thank you for providing SSE with the opportunity to comment on the above Proposal.

Summary

SSE is disappointed that Ofgem released their final decision before a more holistic review including Alternative Modifications and Further Interventions were shared with and considered by the industry. This means that more suitable solutions for enhancing security of supply have not been developed such as centrally administered Demand Side Response. SSE does not support Ofgem's proposed Final Decision because it will not improve security of supply. In addition, interactions with the electricity market will have unintended material consequences for physical energy security.

SSE's core purpose is to provide the energy people need in a reliable and sustainable way. Given that the UK will become more import dependent on gas, SSE is supportive of unfreezing the cashout price once a Gas Deficit Emergency (GDE) has been declared as this could help to attract additional gas to the UK. However, the proposal to have a capped cashout of £20 /th will set an arbitrary, high target price that will distort the market and cause bankruptcy. Coupled with the low probability of occurring and the detrimental impacts of socialisation of compensation the Proposed Final Decision will not reduce the likelihood of a GDE from occurring.

SSE believes that the best means of enhancing security of supply and preventing a GDE is through the unfettered operation of the market which places incentives on Shippers to balance. Shippers will manage the risk of an unfrozen cash out price through a variety of means including: contracting for physical supply; storage; NBP contracts; and physical gas production.

Unintended Consequences of the Proposed Final Decision

SSE is not supportive of Ofgem's Proposed Final Decision, a capped cashout of £20 /th will set an arbitrary, high target price that will distort the market and more likely to cause bankruptcy than letting the market find its own level. Socialisation of compensation causes perverse incentives not to deliver additional gas once an emergency is declared and not to invest to avoid an emergency, in particular:

1. Capping the cashout price at the proposed VOLL of £20/therm. This will act as a target price for additional gas supplies and demand side response which in its absence would have been lower. Historic evidence has shown that gas demand by DM customers reduces voluntarily when price has risen above £1-2 /th. A target price of £20/therm will exhaust credit lines for trading and limit liquidity preventing gas from being delivered to the UK.
2. Paying compensation at the level of £20/th to interrupted customers. It is not clear why Ofgem believes that a customer would face different costs if interrupted for network or energy reasons. If compensation is deemed to be necessary, SSE believes that the compensation methodology already used by Gas Distribution Networks is appropriate for a GDE.
3. The socialisation of compensation payments. We think these proposals are more likely to lead to the bankruptcy of shippers through their inability to meet cashout or compensation payments. This will then lead to inappropriate socialisation of costs to long shippers who have made prudent provision to secure gas supplies. They may then subsequently become bankrupt due to the unpredictable socialised costs incurred that require large cash deposits at short notice. In extremis this could continue until only one Shipper is left and the industry becomes bankrupt.
4. Socialisation of compensation will be based on throughput of gas through the neutrality mechanisms, this means shippers who deliver more gas post GDE will pay greater costs. This will dis-incentivise shippers from sourcing more gas and could mean the emergency lasts for longer than it otherwise needed to. To avoid these socialisation issues compensation paid should be limited to the amount collected from short shippers.

Impact Assessment and Electricity Market Interactions

Ofgem have excluded the impact on the electricity market of the gas SCR. SSE are disappointed by this because of the importance gas will have as a future fuel source for electricity generation and interactions for UK energy security.

SSE consider that the development of the Electricity Market Reform (EMR) arrangements and potential penalty mechanisms for non-delivery of energy under the capacity payment mechanism to be material new information which require Ofgem to reconsider its Proposed Final Decision. It is possible under the non-delivery of energy penalty mechanism for gas to continue to be burnt to avoid a higher penalty. The

consequence of this will be an accelerated trajectory to a GDE because voluntary demand side gas reduction will be penalised.

Once a GDE has been declared the NEC will then determine which CCGTs are to stop consuming gas. This arbitrary selection will create winners & losers to exposure of the non-delivery of energy penalty mechanism. This potential for unfairness necessitates a review of the interactions and incentives between the two markets.

We have the following comments on Ofgem's impact assessment:

1. No consideration of the impact of increased credit cost requirements that will result from these reforms.
2. No consideration of the impact of decreased market liquidity that will result from these reforms.
3. No consideration of the impact of forcing a target price of £20 /th rather than allowing the market to self interrupt at a lower price.
4. Only 2.4 m th of gas are assumed to be interrupted, table 4. SSE consider this to be a large underestimation, we consider a number up to 10 times this i.e. up to 24mth/day or 75 mcm to be a more realistic value, if Easington or Milford Haven failed. The compensation costs of this higher value, which is likely to be socialised, have not been adequately modelled or considered.
5. The assumptions around the frequency of emergencies have still not been realistically reflected in spite of previous comments made to the draft proposals. For example, the interconnector is assumed to have a 50 % failure rate in Winter. i.e. once every 2 years. We note that the IUK has only failed for 13 hours in 7 years.
6. There is no diversity for short/mid range storage, they are treated as a single block which over states the impact of single asset failure.
7. No LNG is assumed to be in storage, 1000 mcm of gas can be held in LNG storage, and the average over the last 2 years has been 708 mcm. This over estimates the likelihood of an emergency occurring.

It is disappointing that the Impact Assessment has been made on assumptions that are questionable and that important costs and interactions have been ignored.

Preferred Solution

Security of supply will be further enhanced by implementing a centrally administered Demand Side Response (DSR) mechanism that feeds into an uncapped dynamic emergency cashout price. DSR offers the quickest, cheapest and least disruptive route to enhanced security of supply. NGG would run an auction similar to the Operating Margins contracting process to obtain a predetermined level of load shedding ability. This would be exercised after a gas deficit warning and prior to a GDE which should avoid an emergency occurring. DSR has the following benefits:



1. NGG, shippers and customers have certainty of required actions & volumes in advance of a tight supply scenario leading to swift response.
2. DSR guarantees a physical response, confirmed by metering and not just financial contracts and insurance which don't improve physical security.
3. The DSR exercise price will feed into the cash out price and because it has been discovered by auction will be the most competitive and work with the grain of the market.
4. NGG will contract for the desired amount of DSR, ensuring an efficient result by avoiding over contracting.
5. Not all Shippers have access to DM customers and a centrally administered auction will have greater diversity in its composition.
6. The independence of NGG and the trigger mechanism has the benefit that customers know that the interruption is free from any commercial price arbitrage. This is a significant advantage over direct shipper customer contracting.

SSE therefore consider it to be in the best interests of future operation of the UK energy market to desist from implementing the Proposed Final Decision and allow development of modification 435, which will enhance security of supply by making an emergency less likely to occur.

Please do not hesitate to contact me if you wish to discuss this further.

Yours sincerely

Jeff Chandler
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