17 October 2012

Ofgem
9 Millbank
London
SW1P 3GE

Re: Gas Security of Supply Significant Code Review - Final Policy Decision

Statoil (UK) Limited (STUK) understands the initiative to review security of supply in the UK as a prudent measure to ensure that the existing regime is fit for purpose. However, we are extremely concerned that the existing proposals do not fulfil Ofgem's objectives of sharpening shipper's incentives to bring gas into the UK transmission system in the event of emergency nor reduce the likelihood, duration or severity of interruptions. Indeed, STUK are of the view that these proposals could be extremely damaging to the GB wholesale gas market. Further, it is of concern that Ofgem appears to have lost faith in the capability of the current market arrangements to deliver secure gas supplies, in spite of an increase in supply diversity in the UK year on year and the development of the most liquid wholesale gas trading hub in the European market.

Whilst it is STUK's view that the current UK market arrangements are sufficiently robust, we welcome the willingness of Ofgem and DECC to consider moderate reforms that could improve security of supply going forward, particularly in the context of managing increasing volumes of intermittent renewable energy and tightening electricity capacity margins. However, the extent of regulatory change currently taking place in the UK energy market is significant, and the full details of Electricity Market Reform have not yet been published or finalised, so it is extremely difficult to assess their full impact on energy markets. The principle issue relating to gas, the capacity market, is still very much in development, with detailed design yet to be completed.

The Government's Energy Security and Gas Generation Strategies, to be published later in the autumn, will clearly have a considerable impact on behaviour and investment decisions in the GB energy sector. We would therefore urge Ofgem to suspend this Significant Code Review process to allow sufficient time to carefully consider their proposals alongside industry presented alternative and wait for the

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Government's thoughts on market intervention measures. It is of paramount importance to all stakeholders in the UK gas market that the industry finds the optimal solution to ensure that security of supply remains robust as the energy mix evolves and that the UK gas market remains competitive and attractive.

STUK provide comments on key implementation issues later in this response but due to the potential increase in the risk associated with GB market activities if Ofgem's proposals are implemented, it seems appropriate to outline once again our concerns relating to the proposed changes to emergency cash out prices:

1. £20 per therm as an administered price will bear no resemblance to the market at the time whatever the conditions. It is nearly 10 times higher than the highest price in the last 10 years (in 2006 when the Rough Storage facility went down) and 4 times higher than the **highest ever** SMP Buy price in the UK.
2. We are concerned that the introduction of £20 per therm will have significant impacts on both the Irish and Continental North West European markets, polluting other markets and as a result increasing both traded prices and the cost of flexibility.
3. The implementation of Ofgem's changes is not likely to result in a significant increase in immediate availability of gas stocks. It is likely that producers will already be flowing at maximum levels in response to price changes and customer requirements, whilst LNG cargoes cannot respond quickly enough to short term price changes, even if able to, depending on existing contractual commitments.
4. STUK does not believe that such a high risk/low probability event will incentivise certain investment behaviours ie the building of new storage. It is our view that the industry's efforst should be focussed on incentivising demand side response behaviour, which we believe, as a centrally procured service on behalf of shippers/suppliers has significant merit as a meaningful alternative.
5. £20 per therm will act as a target price both for traders in the market, which will result in the prices escalating far more rapidly to £20 per therm (as illustrated in the Italian market when a price cap was introduced) adversely affecting liquidity in the NBP market both prior to and post an emergency.

6. Customer are likely to insist on £20 per therm for interruption clauses as this is the price in the market, thereby preventing meaningful price discovery on the real value of interruptible contracts to both end customers and suppliers.
7. The credit implications of the proposed changes are significant; the imposition of £20 per therm considerably increases counterparty risk and will have a major impact on credit lines with National Grid. It is clear that Ofgem has not conducted any a significant analysis on how many shippers would face severe financial distress in an emergency situation if £20 per therm cash out was in place.
8. The interaction with the capacity mechanism is key, as it is likely that system stress in both gas and power sectors could occur at the same time. It is essential that the interactions of the any cash out mechanism and the capacity mechanism cash out regime is carefully considered so as to prevent perverse signals and behaviours which could result in it being more economical to shut off domestic consumers than CCTGT's due to the level of penalty payments for failing to generate at times of system stress.
9. What will be the real cost to consumers? The proposals in this consultation, in particular with respect to VoLL, serve to increase risk and uncertainty. If shippers do have to heavily insure themselves against such a risk then these costs will inevitably be passed down the supply chain to consumers.

Implementation issues

NDM portfolios:

At the workshop on 7 September, it was clear that Ofgem had not factored the NDM market into their considerations particularly with regard to its assessment of DSR requirements. Shippers at the meeting expressed concern that as the P70/ECQ process was not able to be used for NDM customers, the result was that NDM customers could not be part of the Demand Side Response 'DSR' arrangements. The consequence of this was it would be extremely difficult for NDM shippers to balance their portfolios in an emergency. We recognise that the drafting places the burden of proof on NDM sites to show that they have curtailed their supplies, but believe that further work is needed to ensure that timings and process will allow NDM sites to be excluded from the ECQ process.

DSR pot and neutrality smearing:

Following the legal drafting session on 8th October, it is clear that there are some significant issues that need further discussion and could have a material impact on the current level of neutrality impact to which shippers are exposed. The use of £20 per therm as a marginal cash out price and the high level of probability of shipper default will result in a step change in the magnitude of financial exposure. Even if a shipper has successfully balanced its portfolio, it could still pick up a considerable level of socialised costs, particularly if it is supplying significant volumes to the UK. This creates perverse incentives placing potentially large additional unquantifiable costs onto those participants who will be behaving in the required manner in a gas deficit emergency by bringing supplies into the National Transmission System at a time of extreme need.

Credit limits and Energy Balancing Credit rules:

STUK strongly urges that Ofgem ensure that robust analysis is carried out to assess how quickly existing credit lines would be breached and as a consequence the numbers of shippers that would be in severe financial distress. It is essential that any changes to wholesale gas arrangements do not create barriers to entry or have a detrimental impact on the competitiveness of the GB market.

Suspension of VoLL at stage 4 restoration:

It is STUK's view that further consideration should be given to whether it is appropriate to retain VOLL until the gas deficit emergency has formally ended. A move back to a market based price at an earlier stage may improve liquidity in the market more quickly.

Significant Code Review Process:

We do not agree with Ofgem's approach in using their power under the Energy Act to implement this change. It has consistently been our view that these proposals should be discussed with the industry and progressed as part of the usual modification process. Via this route, meaningful alternatives can be appropriately considered to ensure that the optimal solution for the GB gas market is found.

Conclusions

It is evident from all of the discussions surrounding these proposals that there are a number of consequences and flaws that lead many parties to conclude that these proposals as they stand, are both inappropriate and unworkable and could have a detrimental impact on diversity of supplies, NBP liquidity

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and the attractiveness and competiveness of the GB gas market. The consequences, should a gas deficit emergency ever be called, would be far reaching and significant.

Given the complexity and importance of the issues at stake and the level of impact that the proposals will have on the UK gas market, STUK would strongly urge that SCR process is suspended not only to facilitate a more comprehensive assessment of the alternative options available, particularly the recently raised Centrica modification, but also to tie in with the Government's Energy Security Strategy.

STUK looks forward to hearing Ofgem's further views on this issue would be happy to meet to discuss any of the issues raised further. We trust that Ofgem will carefully consider the comments raised in the meetings and in consultation responses, and urge Ofgem to consider alternative initiatives to ensure supplies to the UK remain secure.

Yours sincerely

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Statoil (U.K.) Limited

Due to electronic transfer this has not been signed

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