

Anjli Mehta
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

24 September 2013

Dear Anjli,

RE: Gas Security of Supply SCR – Demand Side Response Tender Consultation

Thank you for providing the opportunity to comment on Ofgem's demand side response (DSR) proposals.

Centrica's view on including DSR in the SCR scope

Centrica has long supported the concept of engaging large end-user customers in voluntary DSR processes as a means of protecting supplies to the more vulnerable in society. Indeed it was primarily as a result of the omission of DSR considerations from Ofgem's original SCR proposals that Centrica raised UNC Modification 435.

Since then, there has been significant debate about the merits of various DSR options and their impacts on prices/costs. Much of this has been extremely constructive, yet it is increasingly becoming apparent that this is a very complex area which requires careful consideration. It is particularly difficult to ascertain customer appetite for such a product, or predict the prices and volumes that might result.

Added to the inherent complexity of designing a workable and equitable process is the uncertainty created by far reaching and still evolving changes in the electricity market which could radically alter the incentives on how gas fired generation plant might respond in certain situations. For example, developments in the design of the Capacity Mechanism (CM) have created the real risk that using a DSR process to identify the non-domestic VoLL could result in extreme prices, set at a level to cover any potential financial penalty users within the CM would face for failing to generate.

We continue to support the concept of economic DSR as a valuable supply security enhancement tool and believe that a workable and beneficial solution may be possible. The DSR discussions over the last 11 months have also reaffirmed our view that where there is customer appetite for voluntary DSR amongst DM customers, any process to secure it must be led by National Grid as system operator, or another similar body.

However, our support for any of Ofgem's DSR straw men is significantly tempered by a couple of key factors. First, while this subject has been under discussion DECC has confirmed that CCGTs who are part of the Capacity Mechanism will not be provided relief from CM penalties for failure to generate as a result of a cessation of their gas supply (e.g. under a gas deficit emergency). This decision is counter to our initial assumptions, and means that generators will require far higher exercise prices for participation in any gas DSR arrangements in order to mitigate their risks in the electricity market. This has fundamental implications for the level of any non-domestic VoLL set through a DSR process.

Second, we are concerned at the underlying principles upon which Ofgem has chosen to develop its straw men. These principles diverge notably from much of the discussion surrounding UNC modification 435 and which had widespread support during the subsequent development discussions. These include:

- A customer defined option fee. We heard from customers that this was necessary in order to fund the back-up facilities specific to their site(s) which in turn would enable them to offer economic interruption services;
- A multi-year product. Customers told us they would be extremely unlikely to make a new investment in back-up facilities, or delay a decommissioning decision, on the basis of a single year-only DSR product:
- Safeguards around extreme prices. While some of the strawmen include features which might limit the payable price and therefore cap cash-out (and hence wholesale) prices, others do not. We recognise the potential benefits of a cap, but are concerned that any capping mechanism might over time be lifted, thereby increasing the extent to which DSR might drive inefficient cash-out prices.

We are in particular concerned about this last point; the potential for a DSR process to drive payments to customers – and hence cash-out and wholesale prices – to the level required to compensate CM participants for any penalty they may face for not generating when required under that mechanism. Such an outcome would be inefficient and uneconomic for customers who have to pay for this, and would add significant risk for gas shippers who in turn will pass through the cost of this risk. It is also unlikely to reflect the true VoLL genuine non-domestic customers would set under 'normal' DSR auction conditions.

Including artificially high, backstop VoLLs in the DSR mechanism pollutes the concepts of DSR and undermines the valuable role that DSR could play in averting a gas deficit emergency. The effects of this will be to push up cash-out prices to unnecessary levels, not only within an emergency, but ahead of an emergency even when a gas deficit emergency is remote. This in turn would distort wholesale market prices to the detriment of any shipper with unhedged gas requirements not just on the relevant day, but over an extended forward period. There would be corresponding effects in the electricity market to the extent this is driven by gas. These costs have not been captured in the prevailing Impact Assessment.

We are also mindful of the limited and falling amounts of back-up fuel capability in existence, which in our view is where the real economic benefits of DSR can be found. This could result in a position where the SO-run tender process becomes a distressed buyer, leading to further price inflation.

On balance, we conclude that the models for DSR proposed by Ofgem are likely to be unattractive to customers. They would also serve to increase the risk of extreme cash out prices and would do so earlier in the process than would be the case without DSR. We therefore do not believe that a

structured DSR process should form any part of the on-going SCR. If DSR is to be considered, it should be developed completely separately from the SCR, and only once the current SCR proposals are concluded. The role of DSR in setting cash-out prices also needs further consideration.

Broader view on the Gas SCR

It's been around 12 months since the last consultation on this matter and we note that during this time, Ofgem has revised its thinking on certain aspects of its SCR proposals. Perhaps most notable is the movement in domestic customer VoLL from £20/th to £14/th. While any reduction of the previous figure is to be welcomed, we are of the view that the revised figure of £14/th is similarly unsupported by any evidence base, not least the work commissioned by Ofgem from London Economics.

We cautiously welcome the greater role of market based pricing throughout a GDE under Ofgem's revised proposals, but note that this concept will only have any relevance where it remains unpolluted by artificial compensation requirements for consumers.

We welcome Ofgem's recognition that its previous model of socialising compensation under-recovery through neutrality would provide counter-intuitive incentives on shippers to deliver discretionary gas during a GDE. We note Ofgem's intention to revisit this, but caution against any model which seeks to socialise compensation under-recovery through neutrality, noting that any such arrangement is likely to be discriminatory and distort incentives on shippers to deliver discretionary gas.

We also welcome Ofgem's intention to conduct a further RIA. We remain of the view that the previous RIA was grossly deficient and sought to exclude swathes of costs – at least some of which could be reasonably modelled and quantified. We remain of the view that the true cost to consumers of these SCR proposals is significantly higher than previously stated.

We note the recent decision by DECC not to undertake any form of further interventions in the gas market in support of gas supply security. While views may differ about whether this decision was right or not, we do note in particular the confidence which DECC places in the operation of the GB market. We remain of the view, however, that the SCR proposals do constitute an intervention into the proper functioning of the gas market albeit under a different name. As such they risk unnecessary cost to consumers as well as unintended consequences.

We consider that incremental changes can be made to emergency arrangements, but that the underlying market functions well and there should not be any high risk measures that will simply add risk to the GB market as a destination.

Conclusions

Centrica's position remains that we do not support the SCR proposals as they stand. We believe they are flawed for reasons well documented in our previous responses to SCR consultations. These include:

- Failing to take any account of the impacts of extreme gas cash-out prices – as driven by the SCR – on the electricity market. This is a real impact which could be reasonably modelled, but hasn't been.

- Massively under-stating the true cost of these reforms to consumers, and for negligible supply security benefits;
- Excluding from the IA the impact of this cash-out reform on wholesale gas prices within and outside of a GDE;
- Incorrect value placed on domestic customer VoLL
 - London Economics' research is flawed both in terms of the way questions were asked, and the value that was put to respondents as the prevailing security level. Both of these factors serve to inflate the overall VoLL figure.
 - Ofgem's use of average winter consumption as the divisor, whereas Redpoint's analysis clearly shows that the only failure occurs in an extreme winter scenario.
 - Assigning the domestic VoLL level to all NDM consumers , whereas in reality the NDM sector is comprised of SMEs and other retail customers who, according to LE, have much lower VoLLs than domestic consumers.
- Failure to consider the costs of the energy credit impacts of these proposals.
- Over-reliance upon qualitative factors in preference to rigorously modelled quantitative figures.

The detailed changes to the SCR proposals over the last year, although welcome, have done little to assuage our opposition and all of our points of opposition remain, to a greater or lesser extent.

Notwithstanding our opposition to this overall reform, were Ofgem minded to pursue its SCR, we believe it should do so without any element of structured DSR at this stage.

Yours sincerely

Chris Wright
Commercial Manager

Appendix 1 – Responses to DSR questions

CHAPTER: Two

Question 1: *What are your views on a SO-run DSR tender? Do you think it is an appropriate addition to the Gas SCR?*

We have championed the inclusion and investigation of DSR as a gas supply security tool, and the feedback we've received from customers is they would be much more comfortable – and therefore likely to participate – if the DSR tender and exercise process was under the control of National Grid. However, for reasons set out in our accompanying consultation response, we cannot support Ofgem's preferred approach(es) to DSR.

Question 2: *What do you think the purpose of the tender should be?*

To secure an appropriate volume of voluntary interruption at economically efficient prices and to avoid the risk of setting extreme prices that do nothing for attracting additional supplies.

Question 3: *What benefits do you see a DSR tender providing?*

An appropriately designed and operated tender process might deliver valuable supply security to more vulnerable customers by reducing demand on the system when the supply/demand balance is tight. This might reduce the likelihood of involuntary interruption, and/or the severity of involuntary interruption.

However, given that this will be a new service and there is no real understanding of the amount of available (and economically priced) DSR we are concerned that any benefits can be quickly undermined by poor policy design.

Question 4: *What costs do you see arising from a DSR tender?*

Within the current framework of DSR discussions, to be effective we believe that both option and exercise payments should be permitted. There may be certain additional costs on National Grid in its role as central administrator for which it should be reasonably compensated. However, there could be additional models of simple DSR design with exercise only fees, ringfenced from cash-out, which could be explored. Exercise fees could, for example, be recovered through commodity charges, as with OM gas.

There are risks that poor policy design could result in only small amounts of DSR having a disproportionate impact on prices adding significantly to wider industry risks.

Question 5: *Do you think a DSR tender should have a role subsidising investment in back-up facilities? If so, why?*

It is not clear what the subsidy elements of the proposal might be. A DSR service could involve option fees that the DSR seller might use to fund back-up fuel facilities. A successful bid for DSR payments should be undertaken on a competitive basis.

CHAPTER: Three

Question 1: *What do you see as the key design issues for the high level design of a DSR tender? Are there any we have not included here?*

Customers have told us that they would require an option fee choice. We agree that option fees can be useful for encouraging greater participation, providing this was tendered in a competitive environment. Customers have also told us that multi-year agreements, as found in gas Operating Margins and certain electricity balancing services contracts, are essential were investment required.

We are increasingly concerned at the interactions between the gas and electricity markets which could see prices ratcheted up to extreme levels. We would therefore like to explore in more detail a design option which breaks the link between DSR and cash-out.

Question 2: *What are your views on having variable option fees in the tender? Do you have any concerns about the costs that these could impose irrespective of a GDE actually occurring? How should these be funded?*

As above we believe that variable option fees are likely to be necessary for a DSR process to be a success. Providing the correct incentives are set for customers (e.g. no compensation in the event of involuntary disconnection) we would not be concerned about the relatively small socialised cost of this. These costs could, for example, be funded through SO charges.

Question 3: *What are your views on the eligibility of gas-fired power stations? How should the interactions with the electricity market be managed?*

Gas and electricity market interactions could have become much more of an issue with the advent of greater clarity in the current far reaching electricity market reforms. While we believe it may be inherently wrong to exclude CCGTs from the DSR process, we believe that reforms to the electricity market may have altered the extent to which CCGTs may have otherwise helped to secure the gas system.

Question 4: *Could participation of gas-fired power stations have a negative impact on the tender, or on the gas market as whole? If so, can you suggest any steps that could be taken, or an alternative mechanism that could be created, that would help mitigate these concerns?*

We would be concerned about the inclusion of gas fired generation in any DSR process without significant additional thought being given to policy design – particularly the impact on prices.

Question 5: *Do you have any views on what consumers whose bids were unsuccessful should be paid if they are firm-load shed?*

Such payments should be set at a *de minimis* level.

Question 6: *What are your views on the response type the tender should contract for?*

We believe such details would need to be developed in association with National Grid and end-user customers.

Question 7: *What are your views on a minimum volume threshold? Do you have any ideas on how this could be set? Should there be a limit on the number or size of tranches that consumers can bid?*

Some of these details were discussed as part of the UNC Modification 435 development. Again, we believe that they should be refined in association with National Grid and end-user consumers.

Question 8: *What is your preferred length of time and/or frequency with which NGG may exercise a DSR contract? Do you have a preferred minimum response time if a DSR contract were to include one?*

Again, these are detailed design issues which still need to be developed.

Question 9: *Do you have any views on any other tender design issues?*

No.

CHAPTER: Four

Question 1: *What are your views on the three straw men?*

We do not believe they are appropriate designs for a DSR process. As such, we have no further responses to offer in this section.