

Gas Security of Supply Significant Code Review – Demand Side Response Tender Consultation

Consultation Response

Energy UK is the Trade Association for the energy industry. Energy UK has over 70 companies as members that together cover the broad range of energy providers and suppliers and include companies of all sizes working in all forms of gas and electricity supply and energy networks. Energy UK members generate more than 90% of UK electricity, provide light and heat to some 26million homes and last year invested over £10billion in the British economy.

Energy UK welcomes the opportunity to provide comments to this consultation having actively participated in the workgroup meetings since the Significant Code Review (SCR) was initiated.

Key points:

Energy UK recommends

- a cautious approach to any DSR tender
- ring- fencing DSR from cashout
- a trial period to establish proof of concept
- a test applied to bids to assess competitive bidding

Energy UK has been supportive of the development of a DSR tender but given recent developments is now more cautious. We have reservations over how any accepted bids would interfere with the normal operation of the market and consider that if DSR is taken forward it should be ring-fenced from the SCR and decoupled from cashout until a robust competitive processes are clearly demonstrated.

The Straw Men

Energy UK has concerns with all the straw men, particularly where exercise prices are reflected in cashout due to the potential for unlimited liabilities on shippers. This is a specific concern since the mechanism for recovering shortfall amounts still appears to be an open issue.

All options risk the exercise of a small customer volume at a price that could then set cashout for the whole market which could then distort wider market trading. A price cap is likely to act as a target whilst a volume cap applied rigorously gives no assurance over the price that might be accepted, hence there is little assurance of reasonable VOLL values being established.

To avoid some of these risks Energy UK recommends testing the market for DSR by undertaking a trial utilising the OM tender framework with a budget limit to assess the price / volume and competitiveness of bids that come forward.

Rationale for the Tender

Energy UK supports the principles of a DSR tender run by the SO, We consider this is the best way to establish if customers would be willing to be interrupted prior to a gas emergency and the price they would be willing to accept for providing such a service. This would provide the SO with a certain volume of DSR that it could call on prior to declaration of a gas deficit emergency (GDE). However

given recent developments, including the details of the EMR capacity mechanism, the government gas security policy framework and Ofgem's draft policy decision it is clear that there is an expectation, coupled with strong incentives, for the gas market and in particular gas-fired generation to provide for security of electricity supplies. This has led to us adopting a more cautious approach to gas DSR since:

- Participation by gas-fired generation is likely to be extremely limited or risks the EMR penalty value being reflected in the gas DSR bid.
- Also we are not convinced that there is much appetite for other large daily metered (DM) customers to bid competitively. This is because most of these customers are likely to be protected from load shedding in the event of a GDE due to their size relative to gas-fired generation loads.

The participation, in terms of volume and price, in any such tender and therefore the outcome is highly uncertain. Energy UK therefore considers that it could be appropriate to undertake the initial tenders on a trial basis, such a principle was used during the initial tenders for Operating Margins (OM) services from non-storage providers during the Operating Margins contestability project. We would suggest that during the trial period:

- tests of response are undertaken,
- any exercised bids are not reflected into cashout
- there is an assessment of the competitiveness of the bids before bids are accepted.

The latter could be analogous to that used as part of the assessment of competitiveness of the OM process and decisions on pricing for services from LNG.

Energy UK considers this would allow for:

- The concept to be tested
- Tender design to be refined if necessary
- The avoidance of extreme outcomes
- The market to be protected from distortion by the inclusion of DSR bids directly into cashout

Energy UK considers that if a DSR tender were to be introduced it should not have an explicit role in subsidising investment in back-up facilities at this time, but participants may wish to reflect such costs in their bids.

Key Design issues

Energy UK agrees that Ofgem has identified the key design issues regarding the tender design, bid selection, pricing and payment, but has not yet explored the detailed product design. This needs to be considered; the minimum bids size, turn down / off, the duration- hours / days / time of day, frequency / cap of exercise and potentially locational services.

In this respect we consider that the OM contractual arrangements provide a good starting point. These already address some issues including;

- assessment by National Grid of an option and exercise structure,
- some product design issues,
- scaling of option fees if not able to provide the services and penalties.

The OM framework also provides a means for setting a budget / target spend and for cost recovery whilst ensuring National Grid focus on minimising overall costs. In addition whilst we recognise the desire to 'keep things simple' initially, there is a balance to be struck with facilitating product structures that are attractive to potential participants, whilst ensuring an efficient outcome. Utilisation of the OM tender framework or something similar would allow for refinement of the product and tender design in the future.

Further thought needs to be given on the way any accepted bids would interact with the market as there could be the potential for distortion if bids were called whilst the market was responding to a gas deficit warning (GDW). Procedures will be needed to ensure bids are not exercised too soon, such that the exercise price is significantly above the market level, particularly if there is a reasonable level of liquidity in the market. The lead times linked with the bids will need to be part of the evaluation of bids.

Option Fees

Energy UK sees the inclusion of option fees as an essential feature of the DSR tender process analogous to an insurance premium. We consider it to be necessary to encourage participation given the very low probability of exercise occurring. We consider that variable option fees are preferable to fixed ones since they provide freedom in structuring bids. In the Operating Margin (OM) tender, variable bid structures are also permitted, this demonstrates that a process already exists to assess variable bid structures against each other.

Energy UK does have concerns over the costs that options fees could impose on the industry and has already noted the 'experimental' nature of initial DSR tenders. The question that needs considering is whether it is worth exploring DSR as an option or not? And how much should be invested in establishing whether customers have an appetite for offering such services and at what price? Our view is that this should be explored for a trial period with an assessment of the competitiveness of bids prior to acceptance. As such, the methodology and assessment of the competitiveness of bids will become the most important area for development.

Role of gas-fired power stations

Energy UK does not believe CCGTs should be excluded from participating in the DSR tender, as a point of principle. We consider it would be discriminatory to do so. However there are clearly interactions between the gas and electricity markets. The draft policy decision for the electricity balancing SCR and capacity market create strong incentives for gas-fired generation to generate to the contracted level and beyond at times of electricity market stress. Giving gas-fired generation this key role in securing electricity supplies alongside the penalty regime for the capacity mechanism is likely to severely limit gas generation participation in a gas DSR tender from 2018, but prior to that participation will need to consider the electricity cashout reforms which are due for phased implementation from 2015.

However demand side response may still be provided by gas-fired generation. Gas-fired generation will continue to take operational decisions based on many factors but may well respond to market prices in the gas market by reducing load, as it has done in the past, if the electricity market is not stressed at the time. Where the electricity market is facing a potential supply shortfall such a response is unlikely to be seen. Once any voluntary DSR has been called and there is still expected to be a gas deficit, then protecting the gas-system will take priority over maintaining electricity supplies and gas fired generation may be load shed at stage two of a GDE. These decisions will be taken by the Network Emergency Coordinator outside of the commercial regime, rather than the plant operators or shippers.

In case of any query Julie Cox would be happy to discuss any of the points raised.

Note: This response represents a broad consensus of members' views, and we would point out that National Grid was not a contributor to this response.

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