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24th September 2013

Dear Anjli

Gas Security of Supply Significant Code Review – Demand-Side Response Tender Consultation July 2013

We thank you for the opportunity to respond to the Gas Security of Supply Significant Code Review – Demand-Side Response Tender Consultation. This response is provided on behalf of RWE npower, RWE Generation SE and RWE Supply and Trading GmbH.

Ofgem has set out an updated proposed final decision for reforms to the market rules that would apply if Gas Deficit Emergency occurred. This consultation focuses upon incorporating a System Operator (SO) led demand-side response (DSR) tender into the reforms. We have carefully considered this proposal and provide detailed comments to the specific questions raised in the attached Annex. We would note that:

- We are not convinced that a DSR tender, of the type described in the consultation, should be included as part of the emergency cash-out arrangements;
- 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 in response to clear and transparent market signals. This would allow efficient price discovery rather than prices being set by an administered VOLL;
- We remain concerned that the proposed DSR tender will weaken market signals and may distort competitive responses to any tightness in gas supply;
- Incentives in the gas and electricity markets are mis-aligned. Current policies create conflicting incentives between the two markets, driven in large part by administratively-set VOLLs that are not complementary. From a policy perspective, the two sets of market arrangements need to be more aligned to retain flexibility and security in the gas market; and
- If any additional measures are deemed necessary, there may be merit in extending the SO's current OM procurement to contract for gas that would only be called on as a predefined last resort once other market-led solutions to prevent a GDE had been exhausted.

If you require any additional information or wish to discuss any aspects further, please do not hesitate to contact me.

Yours sincerely

By email so unsigned

Charles Ruffell
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ANNEX 1: Response to detailed 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 are not convinced that a DSR tender, of the type described in the consultation, should be included as part of the emergency cash-out arrangements. Our view continues to be that it should be a matter for customers and shippers to determine the value of providing demand-side services in response to clear and transparent market signals.

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

We are not convinced that a DSR tender, of the type described in the consultation, should be included as part of the emergency cash-out arrangements. We do not understand the rationale for the type of tender envisaged by Ofgem as the incentives and mechanisms for shippers and customers to contract for DSR are already in place .

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

We do not believe that the DSR tender will provide any benefit. Indeed, we remain concerned that the proposed arrangements will undermine market signals and may distort competitive responses to any tightness in gas supply. Consequently, we are not convinced that a DSR tender, of the type described in the consultation, should be included as part of the emergency cash-out arrangements.

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

We are not convinced that a DSR tender, of the type described in the consultation, should be included as part of the emergency cash-out arrangements. In addition to the administrative and running costs, the biggest cost will be that imposed on the market from NGG exercising an offer that sets a high cash-out price pre-emergency. This price may be considerably higher than that which may result from a market response to tightening supply-demand conditions.

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

We do not think that a DSR tender should have a role subsidising investment in back up facilities. We believe that investment decisions by market participants should be on the basis of clear and transparent market signals that enable users to mitigate the risks perceived to their gas supplies and the impact a supply loss would cause. We do not believe that there is a role for “subsidies” for back up facilities in the current arrangements. Indeed we are concerned that any subsidised investment will distort the current market and may create perverse incentives for participants.

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?

Ofgem has set out a comprehensive list of design issues. However, the designs reflect the fact that there is little clarity about the demand-side service that is being procured. Attempting to design a tender that copes with a variety of potential service providers’ requirements introduces complexity and makes it difficult for NGG to select winning bids, even against objective criteria. NGG should simply contract for gas.

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?

We are trying to mitigate a low probability-high impact event. The costs created irrespective of a GDE occurring mean that option fees should not be included in the design.

Question 3: What are your views on the eligibility of gas-fired power stations? How should the interactions with the electricity market be managed?
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. Current policies creates conflicting incentives between the two markets, driven in large part by administratively-set VOLLs that are not complementary. From a policy perspective, the two sets of market arrangements need to be more aligned and drive efficient outcomes for consumers.

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?
Gas-fired stations are fundamental to managing security on the gas network. Absent FM relief in the Capacity Mechanism, it is not clear that gas-fired power stations will participate in any tender. Capacity Mechanism requirements will force gas-fired power stations to book firm exit capacity, adding to the perception of gas system tightness that may not be there and may bring forward the emergency. The incentives created by the Capacity Mechanism may remove flexibility and security from the gas market.

Question 5: Do you have any views on what consumers whose bids were unsuccessful should be paid if they are firm-load shed?
They should not receive any compensation. It is difficult to justify paying customers whose continuing gas consumption contributes to a GDE. Shippers already face strong incentives to avoid being exposed to the short cash-out price and compensating customers will weaken incentives on them to negotiate contracts to deliver services ahead of an emergency..

Question 6: What are your views on the response type the tender should contract for?
NGG should be tendering for gas. This will allow for a simple, homogenous product that NGG can assess against clear criteria.

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?
The customer should offer gas and manage its own specific requirements when setting out its offer. This removes complexity form the overall DSR tender design.

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?
This should be determined by the SO depending on circumstances and anticipated requirements.

Question 9: Do you have any views on any other tender design issues
We have no additional views.

CHAPTER: Four
Question 1: What are your views on the three straw men?
They represent packages of combinations of the various tender design options. The requirement to meet a range of participants' needs means no option, including Ofgem's lead option, are without weaknesses.

Question 2: Do you think a price cap is necessary to limit shipper liabilities?
We support sharpening the signals that come from cash-out by introducing the risk of VOLL for short shippers into the arrangements. VOLL would be a de facto cap and provide appropriate incentives on shippers to contract to avoid being exposed to it. The mechanism to determine VOLL is still up for

discussion but should not be developed in isolation from the electricity arrangements.

Question 3: Do you have any suggestions for how the volume cap in straw man 2 or 3 should be set?
A volume cap should be set transparently and in relation to a defined security standard otherwise it will simply be an arbitrary value.

Question 4: Do you think the volume cap in straw man 2 or 3 is sufficient to prevent inefficiently high DSR bids from being accepted?
Setting a cap creates the problems of accepting a small number of high priced bids in order to reach the required volume or of what the default is should there be insufficient volume offered.

Question 5: Do you have any views on whether or not straw man 2 should be paid-as-bid?
The question of how any shortfall between funds collected through cash-out and payments to customers will be treated is still unanswered. We believe that there was a general agreement to limit payments to funds actually collected. Until this has been resolved, we support the payment option that minimises the potential shortfall. This is more likely to be pay as bid.

Question 6: Do you have any ideas for how a fixed budget for straw man 3 could be set?
We do not support straw man 3 as it includes option fees.

Question 7: Should any volume cap or fixed budget be known to the market ex ante?
It is difficult to answer this without taking a view on the likely level of competition and number of participants in the tender.

Question 8: What do you think of the rationale for having fixed option fees in straw man 3? Why might they be necessary to ensure sufficient participation and competitive bidding?
We recognise the rationale, but think that the risk of no compensation if firm load shed also provides a strong incentive to participate in the market.

Question 9: How could the fixed option fees could be determined?
We do not think that option fees should be included.

Question 10: Do you have an alternative design package that you think better meets the aims of the DSR tender than the three set out here?
The aims of the DSR tender are not entirely clear. We believe that there are already strong incentives for shippers and customers to enter into DSR contracts which would allow efficient price discovery rather than price being set by an administered VOLL. If any additional measures are deemed necessary, we see merit in extending its OM procurement to contract for gas that would only be called on as a predefined last resort once all other market-led solutions to prevent a GDE had been exhausted.