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Dear Anjali,

Gas Security of Supply Significant Code review – Demand-Side Response Tender

Thank you for the opportunity to respond to your Gas Security of Supply Significant Code Review – Demand-side Tender Consultation published on 23 July 2013.

We agree that gas security of supply is a critical issue that demands the closest scrutiny, given the changing UK gas supply portfolio and the likely increasing role of gas within the electricity generation mix, including as support for intermittent renewables.

We welcome the way in which Ofgem has responded to concerns expressed by industry during the SCR process and the way that it has been prepared to work with industry in developing thinking around Demand Side Response (DSR) and the role that it can play in the overall emergency arrangements. We remain supportive of the fundamental concept of DSR and the value that it can bring in meeting the SCR's primary objective of minimising the likelihood of a Gas Deficit Emergency occurring. Proceeding by way of a tender/auction process should in principle also assist in discovery of VoLL, thereby providing a more market-based and cost-effective remedy. We agree with Ofgem's proposal to use a tender process rather than an auction as its greater simplicity is more likely to encourage participation – particularly where the likelihood of it being used in anger is perceived to be remote.

We have some reservations concerning the detail of Ofgem's proposals and the interactions with arrangements in electricity and the likely design of the Capacity Mechanism. We have not responded to the detailed question in the consultation but would like to offer the following observations:

- **The role of CCGTs in the DSR process**

Ofgem's preferred option is to exclude CCGTs from the DSR process. This reflects a concern that CCGTs may submit very high prices in a DSR tender process (as high as £180/therm) if they factor in Capacity Mechanism penalty payments, and that this could introduce distortions into the overall process. Although the VOLL of CCGTs may be very high, there will come a point in any gas shortage where it is preferable to shut down CCGTs in order to avert more costly measures such as gas network isolation. However, if CCGTs are excluded from the DSR, there is no obvious mechanism by which they could be shut down until a Gas Deficit Emergency is declared.

We would encourage Ofgem to consider whether it is possible to take a more holistic view of gas and electricity balancing, and come up with a solution which allows CCGTs to be taken off (even at the expense of moderate power system stress) when it makes overall sense to do so, without having to escalate all the way to a Gas Deficit Emergency. One possible mechanism might be for CCGTs to have a bid accepted in the electricity balancing mechanism. If the CCGT is acting on a System Operator instruction, it would be exempt from any resulting penalties under the Capacity Mechanism rules and would not be commercially disadvantaged. Although bid prices posted by CCGTs in the electricity balancing mechanism would be closely linked to gas prices, they could be much lower than the DSR prices that would otherwise apply. Such a mechanism would be likely to require coordination between gas and electricity system operators, and it may be necessary to modify the duties of the gas and electricity System Operators accordingly.

- **Option fees**

Attracting sufficient volumes of DSR will be central to the tender's success. If such volumes need to be drawn from major industrial users excluding CCGTs (assuming that option is adopted) then we think some form of option fee may well be necessary to encourage sufficient parties into the process. Such fees may also incentivise participants to invest in back-up facilities (or at least maintain those that already exist, given the limited likelihood of the tender being called). That said, we recognise that option fees would impose an immediate and recurring cost and, as with any insurance policy, it is necessary to assess whether the risk covered justifies the premium paid. Whether or not there are option fees, we think that a pay-as-clear tender structure is preferable because it reveals true costs.

- **Potential impact on normal market operations and distortions**

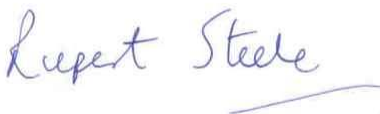
At a practical level, we would note that any DSR tenders should be timed as far as possible to avoid periods when a Gas Deficit Warning (GDW) had been issued. If the market is responding to the GDW at the same time as tender bids are being accepted, that could then feed into cash-out prices, introducing an element of price distortion that may aggravate the situation.

- **Test or pilot project**

There will inevitably be uncertainty surrounding the new arrangements, particularly in relation to participation, volumes and prices – and with consequences that may not otherwise become apparent until the DSR processes are first utilised. As such, we think it would be sensible to conduct an initial survey to gauge levels of interest amongst large consumers who may potentially participate in the tender process. Thereafter, if the survey reveals a sufficient appetite, then it would be appropriate to test the tender process as part of a pilot project. This would allow for lessons learned to be incorporated as appropriate without impacting on the market.

Please do not hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,



Rupert Steele
Director of Regulation