

EIUG Response to DTI Gas Security of Supply Consultation

General Comments

EIUG represents large industrial consumers whose sites typically face the greatest risk of involuntary interruption – without compensation – in the event of a gas emergency. A report commissioned by the DTI from ILEX last winter confirmed that a major disruption to gas supplies would have serious consequences for the UK economy, and particularly for energy intensive industries that depend on secure, competitive gas supplies to remain in business.

EIUG acknowledges that no system of supply is perfectly secure, that there is a trade off to be made between security and price, and that different classes of consumer may be able or willing to be exposed to different levels of risk. We are strong supporters of the UK's market based energy policy, but recognise that this market inevitably operates within a framework established by government. In view of recent events, and likely increase in future risk, we welcome the fact that the DTI is consulting on possible measures to enhance the effectiveness of gas security of supply arrangements.

EIUG welcomes the various initiatives announced in the energy review to speed up the planning process for energy infrastructure of national importance, including gas storage, transportation and storage facilities, and to encourage alternatives to gas fired electricity generation by addressing barriers to investment in secure alternatives like nuclear power. We remain unconvinced, however, that these measures will be sufficient to ensure adequate security of supply in an increasingly import dependent future – especially in view of the potential threats to availability of LNG from the Middle East and piped gas from Russia. Uncertainties also remain about the rate of progress of EU energy market liberalisation which, despite recent encouraging announcements from the Commission, may take a decade or more to be fully achieved.

Risks to security of UK gas supplies are reflected in forward market prices, which in recent years have been high (reflecting market tightness) and significantly above the level of supply prices to large industrial competitors elsewhere in Europe. Large users have therefore had little option but to buy an increasingly large proportion of their gas at floating rates, typically at day-ahead prices, to avoid locking in costs at fundamentally uncompetitive levels. This option is inherently risky – wholesale prices have become highly volatile, to the extent that this may be an unsustainable procurement option for some industries.

Gas supplies are most vulnerable in winter, when temperature driven domestic and commercial demand for gas heating and (increasingly gas-fired) electricity tend to be at their peak. Industrial demand, which is relatively flat, does not contribute to the winter demand peak to any significant degree. As events proved during winter 2005-06, an enhanced physical ability to import gas into the UK, welcome though it is, does not necessarily ensure sufficient gas is available to meet peak demand unless the right contractual arrangements are in place to ensure delivery from external sources and/or sufficient storage capacity is also available within the UK. Large industrial consumers were uniquely exposed to the wholesale prices experienced last winter, which reached unprecedented levels – the highest in the world – as demand was priced off in order to bring the system into balance. In this limited sense the market 'worked' – albeit with regrettable consequences. A number of large industrial users, including those dependent on natural gas as a chemical feedstock that were unable to switch to alternative fuels, were forced to curtail or suspend UK production. Later on, after an incident at the Rough gas facility, the UK came within 24 hours of having to ration gas for industrial use. These events, in a climatically normal winter, damaged production and investment in intensive industries, in some cases permanently – the consequences in a severe winter would have been disastrous.

EIUG remains concerned about the low level of UK gas storage relative to demand which, despite recent new investment, remains well below European and North American levels. We recognise that simplistic storage/demand metrics do not tell the whole story, particularly for a country with significant indigenous production and multiple import facilities, but are nevertheless unconvinced that incentives on shippers and suppliers are sufficient to ensure that storage will be available at levels commensurate with an import dependent future.

EIUG believes DTI should initiate further investigation into the cost and practicality of extending supplier obligations to the Industrial and Commercial sector. We do not support the regulation of gas storage or mandatory requirements to install backup fuel capability at CCGTs or other industrial facilities. We are unconvinced of the need for a capacity mechanism (at least with respect to industrial supplies) or for making further changes to cash out arrangements, though it would be useful to keep these issues under review. We support measures to encourage voluntary demand response from industrial and commercial consumers and to improve fuel efficiency, especially in the domestic sector.

More detailed comments on the measures outlined in the consultation document follow.

Measure 1: Increase supplier obligations to cover industrial and commercial users as well as domestic users

EIUG questions whether the current obligation on suppliers is adequately enforced in practice and, to the extent that it is, whether it is an effective or efficient means of ensuring security of supply to the domestic sector. We understand that suppliers are deemed to meet their obligations by signing up to the Network Code, but are not required to provide specific evidence of their ability to meet likely 1:50 year demand from their domestic customers (in contrast, for example, with practice in oil supplies), so it is difficult to know whether this assumption is reasonable. It is possible that more rigorous enforcement of the domestic obligation would result in less volatile wholesale prices, which would benefit I&C consumers. It is also possible that 1:50 year demand levels are in need of re-appraisal. Met Office data indicates that the UK has benefited from several decades of relatively mild winters relative to historical norms, suggesting a step change in the probability of severe cold weather may have occurred. If so, there are implications for likely peak winter gas demand in the UK, and for the perceived need to isolate large volumes of continental gas storage from commercial use. We believe these matters need to be investigated further, prior to giving more detailed consideration of whether to extend similar obligations to the I&C sector.

EIUG believes DTI should initiate further investigation into the cost and practicality of extending supplier obligations to firm consumers in the I&C sector, including estimates of indicative costs to I&C suppliers of meeting a 1:20 or 1:50 obligation. It is difficult to form a judgement about the demerits of making such a change (including the extent to which increased costs might deter new entrants) without access to this information.

Measure 2: Sharpen incentives provided by cash-out arrangements

EIUG is not convinced of the case for making further changes to the cash out arrangements, which appear to be working satisfactorily, though we accept the situation should be reviewed if Ofgem or others are able to demonstrate a pressing need for change.

Measure 3: Regulate the use of gas storage for security of supply

EIUG does not support the regulation of gas storage. The current lack of / monopoly in long range (seasonal) storage is best addressed by removing barriers to new entrants, such as inefficiencies in the planning regime, thus increasing the level of competition and quantity of gas storage available. There may be an exceptional case for regulating the use of gas storage in emergency conditions, when the operation of the market is effectively suspended.

DTI may wish to investigate whether the fiscal regime could be used to encourage swing capability in existing gas fields in lieu of storage, as a transitional measure, until full commercial access to continental networks and gas storage facilities has been secured.

Measure 4: Capacity mechanisms in the gas market

Capacity mechanisms have the potential to increase security of supply, and possibly also to make prices less volatile, though there are doubts that the resulting increase in security (assuming it materialised) would be obtained at a cost effective price. Recent experience of capacity payments in the electricity market, which resulted in over investment and inefficient operation of assets due to gaming, is not encouraging – though it is possible that a more sophisticated mechanism could reduce these dangers if implemented in the gas market.

Given that security of supply arrangements in the domestic sector are already to some extent politically determined, a case could be made for a capacity mechanism to ensure supply margins are maintained at a minimum pre-determined level, the costs of which should be borne by the sector in which those swing demands originate. EIUG believes it would be useful to initiate a wider debate on this issue, which should therefore be kept under review.

Measure 5: Measures to encourage demand-side response from I&C customers

EIUG supports measures the encouragement of voluntary demand response from industrial and commercial consumers. An efficient demand side to the market is beneficial to security of supply – and essential in exceptional conditions – but a market that routinely relies on significant reductions in industrial demand to remain in balance is fundamentally unsuitable for gas consuming manufacturing industries. If this becomes the norm in the UK, production and investment will inevitably migrate to countries where gas supplies are more secure.

It is not clear to what degree commercial consumers are able or willing to moderate demand in response to short term price signals in a way that is already routine for CCGTs, and to a lesser extent for some highly intensive industrial users. It would be useful to explore if active demand response can be encouraged in the commercial sector, but unwise to assume this will deliver the sort of volumes that will materially affect the supply demand balance.

Measure 6: Encouraging the installation of fuel back-up capability at new CCGT power stations and industrial facilities.

EIUG does not support mandatory requirements to install backup fuel capability at CCGTs or other industrial facilities. We believe market participants are best placed to make technical decisions whether to invest in gas storage, fuel backup or other facilities to ensure that their security of supply obligations are met, or to maintain production at manufacturing sites.

EIUG believes planning authorities and environmental regulators should take a balanced approach with regard to the transport, storage and use of backup fuels at power stations and other industrial sites. A number of our members reported having had constructive discussions with the Environment Agency about the use of backup fuel in the run up to winter 2005-06. We hope that a similar approach to the implementation of IPPC regulations, and other measures that have the potential to constrain backup fuel use, will continue in future.

Measure 7: Smart gas metering and increased efforts on fuel efficiency

EIUG supports efforts to improve energy efficiency, especially in the domestic sectors where the scope for achieving cost effective reductions in peak gas demand is likely to be greatest.

Evidence from other countries suggests sophisticated domestic consumer tariffs can be successful in moderating peak electricity demand without causing damaging social consequences, and that some consumers will moderate demand simply as a result of having convenient access to timely and accurate information on their consumption. If trials suggest smart gas metering could be similarly successful, and at a cost which is competitive with alternative fuel efficiency options, then this measure should be pursued.