Representation

Draft Modification Report

0388 - Fixed parameters for determining Shipper contribution to Unidentified Gas

Consultation close out date: 30 September 2011

Respond to: enquiries@gasgovernance.co.uk

Organisation: **Corona Energy**

Representative: Richard Street

Date of Representation: 30 September 2011

Do you support or oppose implementation?

Support

Please summarise (in one paragraph) the key reason(s) for your support/opposition.

This modification provides a clear cognitive link between the price that LSP customers will pay and the published values that are provided by the Transporters, in line with the Transportation values which are published at the same time. Allowing the cost of unidentified gas to be known in advance will benefit consumers as this can be clearly calculated in advance and displayed in quotations and contracts. Where Transportation pass-through clauses are operated, this will remove the requirement to reconcile an initial estimated position, so significantly reducing administrative costs. It also removes the risk of these reconciliation amounts not being met (by customers who have changed supplier or gone out business for example) and being smeared across all other customers.

We do not believe that there is any impact on wholesale balancing activities. Shippers are obliged to procure gas to the best of their ability to meet the gas demand they are allocated by the transporters. This modification (and indeed the AUGE process) does not seek to reallocate gas and so the wholesale costs of Shippers are completely unaffected. As the level of gas allocated will not change this modification should not be seen in the light of adjusting the risk profile of market sectors in the wholesale market.

Ofgem have indicated that it would be particularly helpful if the following questions could be addressed in responses:

Ofgem understand that the main issue to be solved is the reduction of costs associated with the SAP mechanism. This involves replacing SAP with a fixed price. They are concerned that this may discriminate between LSPs and SSPs, as LSP uncertainty is reduced at the expense of greater uncertainty for SSPs.

Ofgem ask the following questions to better understand the context and scale of the issue, and how the solution will affect parties.

Understanding the processes

1. Would it be helpful to show, through a diagram, how the current and proposed pricing flows are passed through the industry.

We agree with what the proposer has said in its response regarding how the costs of Unidentified Gas will be passed through, namely where a price is fixed and transparent this can be passed through directly. Where there is uncertainty then the Unidentified Gas Charge will need to be estimated and then reconciled with that uncertainty adding risk to the LSP Shipper and cost to the customer through increased risk premiums. (This would result in most independent I&C suppliers charging an increased balancing fee.)

Understanding the scale of the problem

2. The proposal sets out that the existing pass-through mechanism mainly affects approximately 75% of LSP NDM customers. What proportion of all gas goes to these parties?

Corona Energy does not have details however logic suggests that at a minimum the values provided by the proposer in the modification would be consistent with the number of LSP NDM customers who are on such contracts across the market. Equally it could be argued that as the larger contracts tend to have Transportation pass-through clauses that larger volumes of gas would be exposed to the 75% of customers with these clauses.

Understanding the strength of the proposed solution

3. Do you agree LSPs are less able to manage the risk of fluctuating prices and to what extent?

The distinction in this question should be drawn between those customers who have pass through contracts and those who do not.

We have, along with other shippers, previously indicated that fluctuating transportation prices represent a variable and unpredictable cost to customers on pass through contracts as they can be changed multiple times within a gas year. When this occurs, customers can find it difficult to accommodate such relatively short notice charges. Unidentified Gas charges similarly represent an unpredictable cost to pass through customers, who may be unable to meet retrospective invoices when raised. This is different to customers (domestic and non-domestic) who are charged on a tariff price and who typically pay higher charges to accommodate such fluctuations in transportation costs.

4. What is the level of saving made by LSPs under this modification proposal - for example of avoiding administration costs?

We see the primary benefit of this modification to remove such costs from the industry, hence reducing costs to the consumer. We believe that the administration cost savings will be significant. We also believe there will be associated cost savings in reducing the risk that consumers will not pay any reconciliation amounts not recovered from defaulting customers. As stated in the modification the savings for the proposer would amount to around £100,000 a year. This is consistent with the savings that all LSP Shippers will experience in proportion to the size of their portfolio.

5. Would the risk borne by SSPs under this modification proposal increase?

No, it will decrease. As alluded to above, we do not believe that this financial readjustment and the volume of gas purchased by the Shipper to cover its SSP portfolio are linked – shippers will not reduce their wholesale gas purchases in line with the likely reimbursement they will receive under the AUGE process (and indeed by deliberately not purchasing gas to cover part of their portfolio would be going against their licence obligations). Shipper exposure to imbalance costs will therefore not be varied by any aspect of the AUGE process and so risk will not increase or decrease.

Instead SSPs will have certainty on the unit rate that they will be reimbursed for Unidentified Gas, instead of a varying rate based on SAP. This certainty will reduce risk for SSPs. As the majority of large SSP shippers currently pay to hedge this risk, it is surprising that they have opposed this change. (Although given the size of their organisations it is possible that they have simply missed this benefit.)

6. How does the modification proposal affect the allocation of unidentified gas between parties?

The AUGE process does not reallocate gas between parties; instead it compensates the SSP sector for costs that should have been charged to the LSP sector. At present this is a varying and unpredictable financial amount. By providing certainty on that amount, this modification removes risk from both sides (both SSP and LSP).

7. What are the arguments for a shipper not taking on this risk?

Any risk will ultimately be passed through to the customer, usually in the form of a risk premium built into the price. In this case, due to the size and nature of the risk, the risk will quickly be passed from the Shipper to the customer. Providing certainty in the Unidentified Gas calculation will reduce this risk, so reduce prices and so be to the advantage of both the LSP and SSP sector.

8. For a range of different gas price scenarios, how are parties affected? For example, is a long--run increase in gas prices taken into consideration?

We are confident that this modification, by using a market-linked forward price can take into account any fluctuations in the wholesale price of gas. This would be see by the curve being in contango for increased prices or in backwardation for decreasing prices. By contrast, the current process uses a retrospective price which may reflect short-term market volatility, unrelated to the behaviour of the individual shipper or customer.

9. If one sector (SSPs or LSPs) is always going to have to bear the risk set out by this modification proposal, which sector is better able to manage that level of risk efficiently and effectively? At present, how does each sector deal with risk?

As stated above we do not agree that this modification transfers risk between market sectors. Our position above notwithstanding, risk can be easily mitigated by the larger SSP market sector who will incur fewer costs in accommodating in any change in the current Unidentified Gas price as their size will make any risk mitigation process cheaper to procure. On this basis, the SSP sector is better able to handle such risk.

It should also be noted that more independent smaller suppliers are active in the LSP NDM market than in the SSP market where the Big 6 domestic suppliers dominate. As the costs of hedging risk are greater for smaller suppliers this would suggest the least cost option for the industry of hedging any transferable risk would be to hedge this in the SSP market.

Implementation of the proposed solution

10. What are the implementation costs associated with this modification proposal in the following two cases: a) decision is reached before 1 November 2011; b) decision is reached after 1 November 2011?

A decision prior to 01 November 2011 will give Shippers time to incorporate the change into their business solutions they are creating to accommodate the AUGE process. Any decision after this date will increase costs both to Xoserve and Shippers as processes are adjusted at the last minute.

11. If this modification results in losses or gains for LSPs, in comparison to the baseline solution (P229), should they be recovered through the subsequent AUGE process?

We acknowledge that this modification may result in a differing financial amount being transferred from the SSP to the LSP sector compared to the current process. We note that the figures provided in the modification indicate that the SSP sector will receive a higher amount.

We are aware that the proposer has raised a change to the AUGE guidelines document to incorporate a rollover mechanism.

12. Would a further modification be needed to make the adjustment envisaged by the previous point (question 11)?

We do not believe so; any rollover process can be incorporated into the AUGE guidelines document.

Are there any new or additional issues that you believe should be recorded in the Modification Report?

None.

Relevant Objectives:

How would implementation of this modification impact the relevant objectives?

Creating certainty to LSP customers on the unit rate they are expected to pay for Unidentified Gas will remove the need to reconcile initial estimates. This will remove the risk to customers of unrecovered costs being passed on as well reducing administration costs incurred through reconciliation. This modification therefore furthers relevant objective (d).

Impacts and Costs:

What analysis, development and ongoing costs would you face if this modification were implemented?

If implemented by 01 November 2011, the costs to our business will be minimal as we will be able to take into account these changes in the business solutions we are currently developing for Modification 0229. The certainty on Unidentified Gas prices will also result in significant administrative cost savings and reduce the risk of that reconciled customer debt being unrecovered.

Implementation:

What lead-time would you wish to see prior to this modification being implemented, and why?

Please see our response above to question 11.

Legal Text:

Are you satisfied that the legal text will deliver the intent of the modification?

We have not reviewed the legal text.

Is there anything further you wish to be taken into account?

Please provide any additional comments, supporting analysis, or other information that that you believe should be taken into account or you wish to emphasise.

No