Joint Office of Gas Transporters

# 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:** **EDF Energy**

**Representative:** Stefan Leedham

**Date of Representation:** 30 September 2011

### Do you support or oppose implementation?

Not in Support

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

This modification seeks to remove all of the price risk faced by LSP Shippers and pass this to the SSP Shippers; by fixing the price that LSP Shippers are exposed to for unaccounted for gas. This appears to be contrary to the intent of UNC Mod 229 which sought to remove the cross subsidy from SSP Shippers to LSP Shippers and to ensure that risks and costs were appropriately targeted. The main argument behind this cross subsidy, according to Total is that LSP Shippers are unable to hedge the risk of price movements in SAP compared to the contracted price in LSP contracts. We would note that this appears to overlook the basic principles of financial risk management which allow a Shipper to hedge against these risks for a cost. We therefore oppose this modification as it appears to be an attempt to avoid the costs of hedging price risk by passing this risk from LSP to SSP Shippers and consumers. We believe that this would not facilitate competition.

### 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 would note that the pricing arrangements for I&C contracts vary significantly from a fixed bundled tariff rate through to explicit cost pass through tariffs. This proposal appears to have been driven by complexities in the cost pass through sector. It is unclear why the UAG costs can not be included as a cost pass through item at the applicable monthly rate, or why it cannot be priced at the same price as the energy component of the bill and then hedged by the Shipper.

We are also aware that some Shippers believe this modification is required to provide transparency to customers in their contracts, with customers requiring all LSP pass through contracts to state the same price for the UAG energy. We note that this has not been discussed at public meetings and would represent a new issue that warrants further consideration and development. From our perspective we remain to be convinced that customers require Shippers to offer the same price for the UAG energy. It could be argued that customers might expect to be offered different energy prices from suppliers due to different indexation and hedging methods etc. This would then enable them to choose the most competitive supply contract. It would appear reasonable to assume that if the energy prices differed then there are no obstacles to different Shippers offering different UAG costs based on the energy rate offered in the contract.

## 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?*

We are not in a position to answer this question.

## 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?*

We disagree that LSP Shippers are less able to hedge fluctuating prices, regardless of their pricing structure. In particular we note that essentially when offering a LSP contract with fixed, or indexed prices, Suppliers are essentially selling (shorting) a forward contract; which they hedge against by purchasing (going long) a forward contract from the market for a similar volume. This would suggest that LSP Shippers are able to create financial hedges.

With the implementation of 0229 unaccounted for gas attributable to the LSP market will be allocated to LSP Shippers based on market share at a SAP price. Although SAP prices may vary it is worth noting that market shares and volumes are not likely to vary dramatically within the space of 12 months. In particular although the LSP market has the advantageous ability to appeal and so amend their AQs within year, the impact that this has on market share is negligible. It is therefore reasonable to assume that that the market shares set when AQs are amended in October remain appropriate for the next twelve months. It should therefore be possible for an LSP Shipper to calculate the additional kWh of unaccounted for gas that they will be allocated once the AUG statement has been produced. This could then be converted into a correction factor based on expected/contracted throughput. LSP Shippers will be able to choose whether to bundle this within an element of their tariff structure (such as management costs) or pass it through as an explicit line item to their customers. If it is to be an explicit line item then Shippers are able to choose whether to offer this as a simple cost pass through item, or provide it as a fixed cost item.

If the UAG costs are chosen to be offered on a fixed price basis, then again the LSP Shippers has numerous choices, depending on their risk appetite to either hedge against any price fluctuation risk through to leaving their position fully exposed. In order to hedge the Shipper must know the volume that needs to be hedged (which can be calculated from the AUG statement) and the price they are hedging against (which would be stated in their contract).

The simplest way to hedge this would be to go long a forward contract. For example if Shipper T signed a LSP supply contract that they expected would incur 10 units of UAG a day and had offered this to their customer at 20p/unit, then to hedge against any movement in SAP Shipper T should buy a future contract that will sell them 10 units a day at 20p/unit for the period of the contract. In this example if SAP prices increased to 120p/unit then Shipper T would be exposed to a loss of £10 per day on the supply contract as he would be allocated costs of £12.00 (10 units x 120p/unit) but would only be recovering £2.00 (10 units x 20p/unit) from the supply contract. This; however, would be offset by profits of £10 per day on the forward as Shipper T would have the right to buy 10 units for £2.00 but would be able to sell them on the market at £12.00. It is also worth noting that if the future has been bought through a clearing house then this will be financially settled avoiding any trading requirements. Alternatively Shipper T could long a call option at 20p/unit – providing them with the right but not the obligation to buy at 20p/unit to hedge this risk.

If this proposal were implemented then SSP Shippers would be faced with the same choice as to whether to hedge or not. However, it is worth noting that when creating a hedge there is a cost associated with this – as with all insurance products. It would therefore appear that the main intent behind this modification is for the LSP Shippers to avoid these costs by fixing their UAG costs. This essentially provides a free hedge funded by SSP Shippers.

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

As previously identified implementation of this proposal would allow LSP Shippers to avoid the costs associated with hedging SAP price movements. It is unclear; however, what additional administrative costs will be avoided by fixing prices. The suggestion in the workgroup report appears to be that fixing UAG costs would make non-payment less likely. We do not believe that this is a strong argument as it would seem reasonable to assume that UAG costs are only a percentage of total energy costs. It might therefore be more likely that a customer would default on the energy costs. This would appear inconsistent with previous arguments made by LSP Shippers who claimed that UAG was a very small volume for the LSP sector.

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

Implementation of this proposal would move all risk of price movements associated with UAG for the LSP sector to SSP Shippers. Although with the markets in contango this appears favourable to SSP Shippers, the markets could move to a backwardation outlook. In either scenario SSP Shippers would be exposed to risks (either positive or negative) from price movements and they would have a choice to either hedge these risks at a cost, or to allow the risks to float and offset this through the risk premium charged to customers. In either scenario the costs to domestic customers increases as risk is moved from LSP to domestic Shippers.

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

This proposal does not impact on the volume of gas allocated between the LSP and SSP sector, and does impact on the price at which it is allocated. For example if the Allocation of Unidentified Gas Statement (AUGS) resulted in the allocation of 625 GWh of UAG to the LSP sector and 6,250 GWh to the SSP. If the forward price of gas was 1.6p/kWh then under modification proposal 388 this would result in £10m of costs being allocated to the LSP market. If SAP outturn prices were 2p/kWh then the LSP market should pay £12.5m and the SSP market £125m; however, this proposal would ensure that the LSP market remained neutral to the price movement and the SSP market would have to fund £127.5 m resulting in a cross subsidy to the LSP market.

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

The key principle behind modification 0229 was that it would ensure that risks and costs are targeted at those best placed to manage them. This appears to be a reasonable approach, and it would appear reasonable that the LSP market should be faced with the risks. They can then choose whether to hedge these or not. It would appear that the main aim of this proposal is to avoid these hedging costs; however, there has been no strong evidence as to why this is appropriate.

*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?*

As we have demonstrated in our response to question 6 even a marginal change in SAP prices from the long run price could have a material impact on the allocation of costs between SSP and LSP sectors. For clarity we have also used what we believe to be a relatively conservative allocation of costs to the LSP sector, and so this example may under estimate the impact of these changes.

*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 previously noted we do not believe any sector (SSP or LSP) is more efficient or effective at hedging this risk than the other. Hedging is a common concept throughout the Shipping and financial world. This proposal appears more to be aimed at avoiding the costs of hedging this risk.

## 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?*

The evidence from xoserve suggests that the cost of implementing this proposal if a decision is reached after 1 November 2011 are much greater than if one is reached before. From our perspective we prefer as great a notice period as possible on this mod so that we can include this in our pricing strategy.

*11. If this modification results in losses or gains for LSPs, in comparison to the baseline solution (P299), should they be recovered through the subsequent AUGE process?*

Losses or gains for the LSPs should be quantified and include not only divergences of SAP from the index, but also the avoided hedging cost as well as a reasonable rate of return. This would appear to add complexity and costs to any proposed solution and a more appropriate response would be to target risks at those best placed to manage them and for Ofgem to reject implementation of this proposal.

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

We do not believe that the current UAG process or terms of reference allows the appointed expert to take into account any adjustments due to errors in the pricing arrangements. As such a further modification would be required; a simpler solution would be to reject this proposal.

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

We believe that if Shippers with an LSP interest raise the issue of price transparency for customers, then this would constitute a new issue that has not been discussed or developed in public industry meetings that would warrant further discussion and consideration.

In addition we note that the legal text has introduced a new concept to cover instances when the monies payable under the AUGE process do not match the monies received as a result of implementation of this proposal. This is a new issue that has never been discussed or contemplated by the industry when developing this proposal. This also does not reflect the intent of the proposal and the modification will need to be varied to incorporate this change. We believe that this variation would be material and would warrant further discussion as it would change our response to this consultation.

## Relevant Objectives:

*How would implementation of this modification impact the relevant objectives?*

Implementation of this proposal will have a detrimental impact on competition between Shippers and so will not facilitate relevant objective A11.1 (d). Implementation of this proposal will remove the risk from LSP Shippers caused by changes in SAP prices compared to forward prices. This risk and cost will be passed from LSP to SSP Shippers.

A key element of competition is that costs and risks are targeted at those who cause them, or who are best placed to manage them. We note that this was a key factor in Ofgem's decision to implement UNC Modification Proposal 0229. Although re-allocating risks and costs from the LSP to SSP sector may appear attractive to some Shippers, this would re-introduce an element of the cross subsidy that 0229 would seek to avoid. This would be detrimental to competition and have a negative impact on A11.1 (d).

In addition implementation of this proposal would add further complexity to the UNC. We note that in their response Total has indicated that they believe the AUGE could take any mis-allocations caused by divergence between SAP and the index price. As previously noted we do not believe that the current arrangements support this and a further modification would be required, which Total has indicated they would raise if required. Any modification that requires subsequent code changes to address deficiencies would not appear to facilitate the efficient administration of the UNC (A11.1 (f)). This proposal would therefore have a negative impact on this objective.

**Impacts and Costs:**

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

As previously noted the impacts of this proposal on SSP costs is dependant on how SAP moves compared to the index that LSP Shippers have been locked in at. As demonstrated in our answer to Ofgem's sixth question it does not appear unreasonable that these costs are in excess of £12.5m per annum.

SSP Shippers could hedge this risk (as could LSP Shippers if they choose) and there would be a cost associated with this as well.

**Implementation:**

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

We would support as quick a decision as possible on this proposal to ensure that we can take this into account in our pricing strategy. If Ofgem were to direct implementation then we would prefer at least 6 months notification. This would enable us to quantify the risk, decide whether to hedge this and hedge the position.

For clarity we are opposed to implementation of this proposal.

**Legal Text**:

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

We note that the suggested text could be improved as there are deletions and track changes to text that currently does not exist.

We also do not consider that the suggested legal text will deliver the intent of the modification. We therefore believe formal legal text should be provided and this should be consulted upon. In particular we note that:

The modification proposal in section 3 requires that if the ICIS Heren index is not available then: "the Transporters would be required to source a suitable alternative set of published information. It is further proposed that the AUGS should specify the source used for this calculation." However, the legal text provided for E 10.5.2 (b) (ii) leaves the decision solely with the Gas Transporters.

A new section 10.5.4 and 10.5.5 has been added to cover instances when revenue collected does not match revenue to be paid out under the AUGE process and this modification. This is entirely new and is not covered anywhere in this modification. In order to incorporate this into the UNC Mod a variation will be required, which we believe would warrant further consideration by the industry as this concept has never been discussed or developed.

## 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.*

We remain concerned with the speed that this modification has gone through the development process. The industry has worked to support the delivery of a workgroup report, consultation and recommendation to Ofgem in line with the aspirations of the proposer; however, this has allowed limited discussions and developments within two meetings. Given the issues identified in our response we believe this proposal would have benefitted from further discussions and development.

Given the support of the industry to meet the aspirations of the proposer we would also be concerned if some Shippers, or their representative groups delayed development of other proposals because they were opposed to the modification.