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Dear Sonia,

**National Grid Transco – Potential Sale of a Gas Distribution Network Business
Offtake Arrangements**

Thank you for the opportunity to comment on the above consultation document. Statoil (UK) Limited (STUK) hope that the current consultations and the continuing work stream process can deliver a solution that minimises both disruption to competitive markets and protects against increases in costs to Shippers, suppliers and end users.

STUK feel it would be appropriate that Ofgem considers the responses with this RIA with those of the RIA on Interruption arrangements, as the two documents are closely related issues.

Set out below are the views of STUK on the various options for the Offtake arrangements put forward by Ofgem in the above Regulatory Impact Assessment.

Option 1: Transco's initial proposal

This option has the advantage of simplicity but concerns have been raised over the ability it offers the NTS operator to discriminate between Distribution Networks (DNs)

Option 2: DN Booking Model

The models (a and b) defined by Ofgem have the advantage of having a fairly simple initial structure. STUK believe the use of an incentive mechanism to drive down costs may lead to unexpected behaviour if the incentives are not correctly positioned. The structure of the incentive regime needs to be carefully set at an appropriate level. Failure to do this could



lead to the DN making inappropriate trade offs between purchase of NTS capacity and investment in it's own network.

An alternative model (c) was discussed in the CIWG but does not appear in Ofgem's RIA. In this model the DN is provided with regulated revenue for all Exit Capacity charges. These charges are passed onto shippers through the existing mechanism. As revenue would be price controlled each DN would be incentivised to reduce the amount it spent on NTS Exit Capacity, as this would directly affect its bottom line. Overbooking of capacity in such a regime seems unlikely, as the costs would be borne by the DN and not the end users.

Under all of these models STUK believe transparency of how the 1 in 20 provision is being fulfilled is paramount. Perhaps yearly statements should be provided detailing how each individual DN proposed to fulfil its 1 in 20 obligation. These would be independently audited to ensure the measures taken by the DN were sufficient, providing comfort to end-users and customers that the firm capacity they are paying for is actually available.

Option 3: Shipper and DN booking model

The model defined as Option 3 would require significantly more change than the Option 2 models. It would require the creation of mechanisms for Shippers to book NTS Exit Capacity at an off-take level and the creation of a secondary market. It would require that Shippers gain an understanding of the diversified load across an off-take point and across a portfolio to efficiently book NTS exit capacity.

While Ofgem have stated they wish to see a reduction in the regulatory burden, the concept of 'economic and efficient' investment or management does not necessarily lead to a reduction in involvement of the regulator. NGT have shown in the Entry Capacity auctions that they require regulatory involvement through the IECR methodology, despite the use of market signals.

STUK's concerns with Option 3 are as follows:

Shippers do not have the knowledge or data to understand the NTS Exit Capacity requirements.

Currently all the skills, knowledge and historical data used to calculate the necessary capacity required at an off-take point are held by Transco. This is a highly specialised discipline and under this model all Shippers and all DNs would be required to acquire this ability. STUK would question whether this is the most efficient and effective use of resource.

Without the data currently used to calculate the NTS Exit Capacity requirements and information on all the MPRNs in an off-take it would be unlikely any Shipper could accurately calculate it's requirements. As this data would be commercially sensitive it would be inappropriate to provide this to Shippers. As such Shippers will not be able to take advantage of diversified load across an off-take point.



Shippers will have limited knowledge of local storage and distribution network management

Under Options 1&2 the DN operators are able to use local storage and distribution network management as an alternative to NTS Exit Capacity. While these products will still be available, a Shipper will not have a true understanding of how a DN would operate and the interaction this may have on the NTS Exit Capacity requirements.

The regime would naturally favour Shippers with larger portfolios and would therefore be a new barrier to market entry by new Shippers

As large Shippers with existing portfolios will have purchased NTS Exit Capacity for most off-takes they will find it easier to take advantage of load diversification both within their existing portfolio and when taking on additional customers. Additionally the larger the Shipper, the greater the volume of data available to them to assess the correct level of NTS Exit Capacity to book.

A secondary market in NTS Exit Capacity is likely to be illiquid.

It is difficult to see how a liquid market would develop as competition for exit capacity will only exist at constrained exit points. Shippers will be in a position of being a distressed buyer, as the market cannot respond to provide incremental capacity for at least three years.

The secondary market for NTS Entry Capacity has so far been relatively illiquid. Unlike the NTS Entry Capacity market, where a Shipper can either divert the gas to another market/ASEP or re-nominate under an NTS Exit Capacity market, it would be unlikely a Shipper could ask its customer to use an alternative fuel or turn off their gas.

Experience at the NTS Entry Capacity markets has shown that where excess capacity is available, prices have been significantly depressed leading to revenue adjustment. The existence of a 'use it or lose it' regime will further exacerbate this problem as Shippers may find themselves in the position of being a distressed seller.

It should be noted that the suggested use it or lose it regime would be extremely hard to administer as due to the effect of reconciliations and the RBD regime, the capacity believed to have been 'used' by a Shipper could change significantly within a single off-take point after the day. This may make the purchase of such capacity untellable as it may be discovered after the event that such capacity was in actuality unavailable.

Large I&C sites that require significant volumes of capacity will find outgoing Shippers can charge a premium in the secondary market for the capacity required to supply them.

Because of the lack of a liquid market and the large volumes of capacity a large I&C site may require at a single off-take, it is likely that outgoing Shippers could charge a premium for the capacity at constrained off-takes. If the off-take had excess capacity then the incoming Shipper may decide it is willing to take the risk of obtaining use it or lose it Capacity which it would purchase at an extremely low price. The outgoing Shipper would either sell at an extremely low price or lose their capacity. This could be a disincentive to book capacity in advance.

Problems for the Customer Transfer Process and End Users



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Because of the uncertainty booking NTS Exit Capacity rights three years ahead with no guarantees over the possible resale value of that Capacity on a secondary market, it seems likely that Shippers will take a risk averse approach to the new regime. For example, in the domestic market it is likely Shippers will attempt to slightly overbook capacity to ensure they are covered in the event that they gain more customers at an off-take.

Shippers in the Industrial and Commercial market are likely to approach this problem differently as they are not obligated to contract with a customer through a special licence condition. I&C Shippers, through their Suppliers', are likely to prefer longer term contracts that guarantee the customer's business for the period in which they have bought NTS Exit Capacity rights. New contracts are likely to become routinely subject to clauses ensuring that they are subject to suitable NTS Exit Capacity being available and costs to be borne by the end user. Alternatively, customers may find it difficult to find parties to contract with due to a lack of shippers with appropriate capacity rights.

The RIA stated that shippers could gain 'a competitive advantage over other shippers if they were able to understand the NTS Exit Capacity requirements of their customers more accurately than their competitors.' However, customers are already aware of their requirements, which they indicate through their SOQs. Shippers would not be able to obtain competitive advantage through interpretation of this information.

It also seems unlikely that a major factor for an end user in locating a new site will be the cost of NTS Exit Capacity. While end users may consider proximity to energy sources, experience shows that the cost of NTS Exit Capacity is unlikely to be considered until after the site has been chosen.

Shippers may overbook NTS Exit Capacity leading to stranded assets

If Shippers overbook NTS Exit Capacity requirements then Transco as the operator of the NTS will either build more capacity or gather more revenue than it should under an efficient model. If Transco builds the capacity then a move to a more efficient model would result in stranded assets. It is unclear from the RIA how Ofgem envisage the revenue recovery process would work.

Option 4: Shipper booking model

STUK have the same concerns over Option 4 as those stated for Option 3 however it has additional issues caused by the lack of a 1 in 20 obligation.

The removal of the 1 in 20 obligation could seriously jeopardise the safety of the system and supplies to firm customers. Shippers are not in the position to fully understand the system dynamics that are intrinsic in setting capacity levels that ensure system security. Furthermore, expecting an individual Shipper to understand how its behaviour would impact on this system security at an individual exit point seems impractical.

If Shippers were required to provide the 1-in-20 obligation then they would have a greater driver to be considerably conservative in their booking of NTS Exit Capacity almost certainly leading to inefficient asset investment. Domestic Shippers would be particularly vulnerable



to the 1 in 20 obligation as the domestic profile is generally steeper than the I&C profiles which have less weather correction. This would be likely to result in a greater level of conservatism displayed by the Domestic Shippers.

A 1 in 20 obligation would also require each Shipper to provide a Safety Case to the HSE. This would be another significant change in the activity of Shippers. Currently Shippers are unlikely to have the necessary resource, skills, knowledge and experience to be able to do this. STUK would be interested to know the HSE's thoughts on how this could be best achieved.

Diurnal Storage

Under the current arrangements, the NTS manages diurnal storage levels within the DNs. This enables the NTS to undertake a centralised role, ensuring that linepack levels are kept within safety levels. However, if a similar structure were in place following the sale of a DN, that is, the NTS controlled allocation levels of diurnal storage, then it could be stated that the NTS would be in a dominant position by having full control of this operation with the possibility of supplementing the RDNs diurnal storage capabilities. This could lead to issues concerning discrimination by the NTS against IDNs.

STUK would support a structure, where diurnal storage could be allocated by the NTS to both RDNs and IDNs under a planned approach (Option A in Ofgem's document). This would eradicate issues concerning discrimination between RDNs and IDNs by the NTS and enable the allocation of diurnal storage and operational flow requirements to be based on agreed rules defined by the NTS. This process provides for a level playing field for all DNs across the network.

A market based allocation of linepack would not be suitable as it is not a homogenous national product. NGT currently have a number of linepack zones and each is affected by the relative supply demand situation for that region. It is difficult to see how each DN could value a single product, as the level of flexibility would vary across the zones and across each day.

Under the current operational arrangements, Transco exclusively controls linepack levels. They are therefore, able to fully recognise the true value of linepack and its availability. It is difficult to see diurnal storage allocated on a market-based structure, as Transco would have a more comprehensive understanding of its mechanics and value than any other industry member.

As linepack levels are required by the DNs in order to manage their networks both effectively and with safety in mind, they should therefore not be offered under a market-based method. This could potentially lead to situations where constraints could occur if a particular DN were able to purchase higher levels of linepack than other DNs for diurnal storage.

There are also concerns relating to whether the market would be able to react quick enough to address demands for additional diurnal storage and the subsequent consequences of this. STUK believe that diurnal storage is not an appropriate "commodity" which could be traded on a market-based structure as this could compromise safety within the system.



Business Separation

STUK believe that full legal and structural separation between the NTS and the RDNs would essential should the sale proceed. STUK consider this to be of importance in moving forward with this new structure and especially in taking a longer-term view. If separate legal entities are not created with separate transportation licences, then there could be a perception that discrimination by the NTS between the RDNs and IDNs may occur. IDNs in particular are likely to remain concerned about this issue until full separation is seen.

We note Transco's concerns relating to higher costs being incurred if option 3 were implemented, that is, legal and structural separation. However, the industry is preparing itself for major reform to the current structure, where costs will be incurred in order to accommodate these changes. If the industry is to be changed fundamentally it would seem appropriate to develop and implement a solution for the long term.

Governance of Arrangements

Governance needs to be in place to cover the relationship between Shipper, NTS and DN for the booking of all capacity products. STUK believe that this would be best resolved by including the offtake agreement within the Uniform Network Code as it undoubtedly affects all parties.

Cost Benefit Analysis

STUK have concerns regarding the production of the cost benefit analysis. During industry meetings, various costs have been discussed, however, no industry wide consultation has been undertaken in order to ascertain the levels of costs incurred or to identify whose costs they actually are. Whilst we appreciate that a cost benefit analysis is not a straightforward task to carry out, and that quantifying benefits is a difficult task in itself, we would appreciate if Ofgem could provide STUK with details on how and where the numerical figures have been derived from. This will enable more transparency in Ofgem's evaluation of potential benefits.

Overall STUK feel that the Offtake arrangements and booking of exit capacity are fundamental to the operation of the retail market. It is therefore essential that, whatever the outcome of the decision process on the sale of the Distribution Networks, the retail industry can continue to operate effectively and meet customer's requirements.

STUK welcomes the opportunity to comment on this consultation and trusts that our comments will be given due consideration. Should you wish to discuss any aspects of this response further please contact me on the above number.

Yours sincerely

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