



Global Markets & Investment Banking Group

30 June 2005

Nienke Hendriks
Senior Manager, Gas Transmission
Office of Gas and Electricity Markets
9 Millbank
LONDON SW1P 3GE

Dear Nienke,

Response to Ofgem consultation - Gas Transmission - new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs)

Merrill Lynch Commodities Europe (MLCE) welcomes the opportunity to provide views on the Ofgem Consultation – *Gas Transmission - new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs)*. There are a number of important issues raised by the consultation and MLCE believes that these fall under a few main themes that will be the basis for our response.

1. System stability

An important issue raised in the Consultation is the role that system flow changes have played in the significant alteration of calculated UCA prices. While it is reasonable to question whether the modelling is sufficiently flexible to capture these changes when calculating costs for new entry flows, the most important question is whether these flow changes are likely to be further exacerbated or are likely to settle soon into a more steady state.

- The rate of change is substantial given that this has occurred over a period of less than 18 months, and may not yet reflect a settled position as the market begins to understand how new entry flows will be managed. This rate of change should indicate caution for policy makers in rushing to ‘fix’ current UCAs when these could rapidly be out of date should the flow patterns not settle down within the relatively long auction timeframe.
- Given the substantial lack of understanding on what the NTS will look like for several years, there is more chance of adding to the problems as bidders for capacity will become overly focussed on whether there will be large shifts in the value of capacity acquired through the long term auctions.

Merrill Lynch Commodities (Europe)
Trading Limited

Merrill Lynch Financial Centre
2 King Edward Street
London EC1A 1HQ

Tel 020 7628 1000

Global Markets & Investment Banking Group

- We would like to better understand the basis for the flow changes. Are these based on the results from the auctions, the receipt of planning information or Transco assumptions? The debate would also be better informed if we could understand how the UCAs would change within a range of different flow assumptions.

2. Certainty

The lack of confidence in the value of the capacity product will undermine the already weak signals coming from the auctions.

- Ofgem have identified the problems with shippers buying up capacity that looks too cheap and scorning capacity expected to benefit from reduced prices in the long-term auctions.
- There is also a need to consider the impacts of re-marking the value of capacity already sold and whether extreme price changes affect the quality of the investment signals arising from auctions. Large mark to market shifts in value will discourage long-term capacity holding.
- Shortening auction timeframes while a comprehensive review of the UCA approach and the interaction with long-term auctions is undertaken could reduce many of the risks identified by Ofgem under one of its options, and also allows some time for the system flows to settle. This would, however, also require changes to the NPV test.

3. Cost reflectivity

Cost reflectivity is a very difficult concept to apply, and even more so when there is the potential to fix costs for long-term products. Risks emerge as market participants try to guess the direction of charges before committing to buy long-term capacity.

- Long-term sales will effectively lock in unreflective costs and create concerns about cross subsidisation.
- Regular UCA adjustments will do little to improve cost reflectivity and may increase discrimination, as large players will be able to take early decisions on capacity thereby locking in some value.
- This policy value of having reflective costs at an initial point in time but unreflective costs for an extended period appears dubious, and under this environment we would not consider that entry costs are being set on a cost reflective basis.

Global Markets & Investment Banking Group

Impact on new storage investment

MLCE also has specific concerns about the effect of these changes on the development of necessary investment in the gas system, in particular storage projects that could be expected to replace some of the reduced flexibility arising from depleting swing fields. The gas from these fields is typically being replaced by flat gas deliveries from new LNG, interconnector and long distance pipelines.

High UCAs or uncertainty about the level of UCAs will have an effect on the level of storage investment in the UK, and as a result investors will require greater market volatility to achieve necessary returns. The increased market volatility will happen when some storage projects are marginalised so that there is less flexibility available in the system.

We have noted above our views that resetting UCAs without considering the stability of the system or the interaction with long term auctions is unlikely to deliver cost reflective charges over the long term. MLCE also believes that resetting charges should take into account the broader effects on competition and security of supply that will arise from lower levels of storage investment.

- Given a strong expectation of UCAs volatility it will be more sensible to set new UCAs on the same basis as the existing ones in order to level the playing field until more stability is evident. To do otherwise provides little comfort to new entry points, as they will have to lock in the uncompetitive prices in the long-term auctions in order to meet Transco's NPV test, where these costs will not be reflective over the period of the capacity holding.
- We consider that there are a number of assumptions involved in the modelling of UCAs that are not well suited to setting charges for the sale of a long-term product. If the modelling is wrong then there is a very high chance that the higher implied levels of reinforcement required by the flow changes are focussed on any new entry points so that these points may be cross subsidising the large projects creating the flow changes. The storage sites alone would be unlikely to affect such large changes to flows and are therefore being unfairly burdened by these charges.
- When considering reinforcement costs in the calculation of new UCAs, there should be a requirement to assess if the benefits from such reinforcement are also available to other system users; otherwise the costs are focussed unfairly on some new entrants.

A reasonable argument could also be proffered, that storage assets provide some 'public good' elements to gas consumers. This arises because the system operator gets free use of some of the flexibility provided by storage, as commercially it will most often run in

Global Markets & Investment Banking Group

the direction required to solve system issues. These benefits are often ignored, but they should be considered in the overall context of how storage sites are charged for moving gas on and off the system. We would argue that in most instances storage is beneficial to the system so should face zero or very low charges.

Specific consultation questions

Chapter 3 - A method for setting LRICs and UCAGs

MLCE accepts that modelling these costs and charges is not easy within a dynamic network. But the industry needs to be confident that the model is used consistently, is transparent and that the outcomes make sense. There appears to be substantial risk in calculating costs for new or marginal entry flows when the rest of the UCA costs remain fixed. This would appear to leave the new entry point as the sole adjuster if the system has undergone some shock such as a shift in system flows. This problem is exaggerated when baseline capacities for many existing entry points have been calculated such that the levels may be too high, and thus substantial amounts of capacity are quarantined from the market but still add to the risk of higher marginal costs.

- Ofgem has outlined its assumptions when seeking a calculation of UCAs from Transco. Included in this is the absorption assumption, which unfairly discriminates against storage sites in that there is no consideration of substitution of entry flows from existing terminals. This is at odds with one of the usual roles of storage, which is providing gas to the system when there is some stress (usually reflected in increasing prices) and this stress could emerge from lower beach supplies.
- The absorption assumption could imply that storage is adding to overall system demand and this could over-represent any additional reinforcement costs that are needed in an area even if there is uncommitted capacity nearby.
- One reason given for the large change in UCAs is the shift in flows resulting from the ‘auction signals’ arising at Easington and Milford Haven. Changes in the flows are not available to the industry to assess and there is reliance on Transco making the right assumptions about eventual gas flows. We do not understand if there is other information that Transco is using to support its view on the shifts in system flows.

The use of other models may be a good starting point for understanding the sensitivity of outcomes and testing the strengths and weaknesses of different approaches. This could also help with examining the stability of different model outcomes. It is difficult for market participants to gain an understanding of Transcost and its special characteristics, particularly given that it is not possible to replicate or verify some of the main assumptions.

Global Markets & Investment Banking Group

The market may wish to understand how sensitive the outcomes are to minor changes in assumptions including system flows to assess whether the reset UCAs are a reasonable outcome rather than something that starts to resemble a lottery machine. As noted earlier confidence and stability will be important for the success of promoting long-term entry rights.

Chapter 5 – Comparing UCAGs

Our initial views are that the Unit Cost Allowances (UCAs) for the new entry points are significantly out of line with existing UCAs for other entry points and that this will cause competition problems and may result in the delay or abandonment of some storage projects.

MLCE believes that this latest blow to storage investment, along with exit reform proposals reflects a continuing reluctance to acknowledge the role that storage plays in maintaining security of supply, reducing price volatility and increasing flexibility in the UK gas system. The current system and proposed rules are actively discouraging the development of storage investment and we believe that there is a need for a fundamental review of how these assets are treated. We believe that this issue is far more significant than the treatment of other energy issues such as renewable assets in Scotland where explicit subsidies exist. For storage, there is no expectation of a subsidy, but rather, recognition of the value that the assets provide to the system, system operator and consumers.

Without the development of further storage infrastructure in the UK there will be a heavier reliance on European liberalisation to give access to flexible supply. MLCE applies considerable efforts in the liberalisation programme in Europe, but agrees with the Trade and Industry Select Committee and the European Commission that progress is slow. The private sector has responded to these challenges by seeking to invest more in storage, but the level of regulatory and cost uncertainty is undermining these efforts.

The indicative levels for the existing entry points will also create a number of problems for some companies, particularly those that have made a firm financial commitment to capacity at entry points where the price is expected to fall. As noted above, the uncertainty around the permanence of the UCAs will cause significant difficulties for companies planning approaches to capacity acquisition. Overall, greater uncertainty is likely to lead to less long-term investment and early signals of demand above baseline, thereby weakening one of the main reasons for pursuing long term auctions. We have little confidence that the indicative UCAs for the existing entry points are sufficiently stable because the system flows, which are the main driver for change, are themselves very uncertain.

Global Markets & Investment Banking Group

In terms of resetting all UCAs before the next scheduled auctions, MLCE can see the administrative benefits that may emerge from this. However, given the uncertainties noted above in terms of system flow changes and the lack of confidence in the models we believe that it would be a mistake to reset the UCAs only to find that the exercise has to be repeated soon after following further significant shifts in costs. Cost reflectivity is not improved by taking an early decision to reset the UCAs because of the high levels of uncertainty and in particular because capacity has already been sold in the long term auctions. Any benefit would only be marginal, but this benefit could easily be swamped by the costs of introducing greater uncertainty into the process.

Keeping the existing UCAs and setting the new entrant UCAs based on proximity is a better policy answer in this environment. As noted above, we do not believe that this approach is necessarily less cost reflective given the lack of confidence in the stability and modelling of the costs (in particular whether the incremental system costs are properly attributed to large projects causing system flow changes or are focussed on projects that follow). For example, we have no information on the level of certainty attached to the flow assumptions or the levels of flows that Transco have modelled in the system. A more substantial review of LRICs and UCAGs is warranted in order to develop an approach that is understandable, relatively stable in line with long run costs rather than short run events, and fits well with the ability to obtain long-term rights.

Of course the problem with having a longer-term review is that the market now has a reasonable expectation on the direction of UCA charges (subject to modelling changes and a better understanding of the rate of system flow changes) coupled with an ability to purchase 15 years of capacity. One possible solution to this is to curtail the period of the capacity release until some stability is introduced into the process following a review. This will reduce some opportunities for some parties to grab 'cheap' capacity at the expense of other system users. The shortened period could reflect a number of different periods such as the price control timetable or periods based on previous substantial long-term auction demand. Should a shorter period be introduced, there will be a need to consider how new entry points could meet Transco's NPV test based on the UCAs for nearby entry points.

Chapter 6 – Entry points connecting to DNs

A consistent methodology for embedded storage will be important for the development of additional system flexibility. We agree that a full-blown UCA approach could be inappropriate given the nature of many of the proposed facilities.

A negotiated approach may be administratively simpler, but it will be important to impose obligations on DNs to operate in a non-discriminatory manner and to enter into

Global Markets & Investment Banking Group

negotiations in good faith. Some embedded storage facilities will already have an operational history, which will be of use in determining flow rates. We also believe that it will be necessary to have independent arbitration in some circumstances.

The development of embedded storage should be seen as a valuable tool, particularly given the concerns Transco has expressed over the use of NTS flexibility.

Chapter 7 – Further issues for consideration

The draft principles set a reasonable expectation of what the UCAGs should represent and the way in which the calculation of these costs should not interfere with efficient investment decisions. Only the second bullet point raises some issues, as Ofgem should be clear that setting UCAGs to reflect long-term costs should take into account the stability of the system, otherwise this principle cannot be achieved.

With respect to the gas entry auctions, we believe that these provide one of the best systems in Europe for the allocation of capacity. We do not believe that in significant changes are needed to this system, but that it will come under some pressure as different supply infrastructure is developed and the market takes time to settle into an environment less reliant on UKCS supply. Our preference would be for any changes to be incremental.

A problem that comes out of the current auction approach relates to revenue. Over the years the auctions have delivered too much revenue that resulted in much angst over how to return overpayments and more recently under-recovery that has required the introduction of a TO commodity charge. We accept that an auction based system is unlikely to ever achieve perfection in terms of revenue, however we would support the re-examination of whether using UCAs are an appropriate way to set reserve prices, because persistent under-recovery will only commoditise entry costs through the TO charge which could be detrimental to cost reflectivity. Any review looking at the use of UCAs for reserve prices should take into account the new exit arrangements and the overall effects that both changes will have on the collection of revenue.

The NPV test for new entry points has its uses, but it may also raise issues with respect to discrimination for new entry points when compared to the treatment at existing entry points. For new entry points, the NPV requirements mean that the financial commitment to capacity is forced for a number of years, compared with buying capacity at existing entry points that have high baselines, where shippers can choose any period to commit to. We are not convinced that the NPV test adds much value for new entry points as the projects involved are usually substantial and the chances of Transco undertaking investment that is not subsequently used is very low. For existing entry points, Ofgem will need to consider if the rules are sufficiently balanced to manage the risk of under

Global Markets & Investment Banking Group

investment versus over investment. Ofgem and Transco also need to assess whether the auction results are in line with the planning signals coming from traditional surveys.

The process for setting UCAs should be transparent and subject to external audit. We do not believe that leaving Transco to calculate the numbers is an improvement in transparency. As the UCAs are set in the licence Ofgem should have a role in determining these prices, otherwise Transco will be left to determining aspects of its own licence.

In terms of increment size, we consider that more flexibility could be useful particularly for new entry points. For existing entry points more flexibility could also prove useful, but we would need further information on how different increments would affect prices at each entry point. Any additional information on whether expected extra capacity is a small or large increment would also be useful if there is a desire to set bespoke UCAs.

UCA request may be time consuming, but in reality there are only a few applications each year and past experience should have helped to smooth the process going forward. Formalising the process may work well for Ofgem and Transco, but it would be detrimental for investors as it would be a further timing restriction that could extend project delivery by a further six months. Determinations of UCAs should be made as soon as possible, but most importantly Ofgem should manage the expectations of applicants so that the process can be built into business plans.

We do not believe that Transco should charge for setting UCAG's. The cost of system development and investment is already adequately covered in the price control and this activity is not new and unexpected. Transco also benefits where new entry points add to system investment and its asset value.

More regular availability of Transcost could help transparency, but there are elements of the model such as assumptions on system flows that are not clear. Overall, shippers would benefit from Transco explaining how the changing supply scenarios are altering system operation, particularly at a time when it is also concerned about how independent DNs will use system flexibility.

As discussed earlier, resetting UCAs may solve the cost reflectivity problem at a point in time, but this creates inconsistencies with the use of long-term capacity sales. Selling capacity priced at zero for today for the next 15 years will not ensure cost reflectivity and will only create a higher reliance on TO charges to balance revenue shortfalls.

Conclusions



Global Markets & Investment Banking Group

MLCE hopes that it has conveyed its view that at this stage in the development of the UK gas market there is a need to ensure that critical investment related processes such as setting entry charges are designed in a way to provide certainty, stability and cost reflectivity over the period of capacity holding.

The current flux in system flows does not provide the ideal time to reset UCAs without considering if this would simply create more problems and a loss of confidence amongst shippers. The apparent rapid changes over the last 18 months can only indicate that charges could still swing about wildly as assumptions about the new flows become real flows.

Our preference would be for a steady approach to manage this problem with a more thorough review of UCA calculations and consideration of how the long-term auctions work within a changeable environment. We would also welcome a review on how storage facilities are treated under the entry regime as we believe that the modelling approach is more likely to overestimate the impact that storage sites will have on reinforcement projects and the process ignores how additional flexibility can help Transco reduce other reinforcement costs associated with building extra system flexibility.

In the interim period, MLCE considers that investment programs should not be hindered by further review of UCAs and we believe that Ofgem's option 2 provides a reasonable approach to allow this to happen.

If you have any questions on the contents of this response I can be reached on 02079959021 or by e-mail at adam_cooper@ml.com.

Yours sincerely,

Adam Cooper
Vice President
Regulatory Affairs
Merrill Lynch Commodities (Europe) Trading Limited