

Nienke Hendriks
Senior Manager, Gas Transmission
OFGEM
9 Millbank
LONDON SW1P 3GE

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Dear Nienke

Gas Transmission – New NTS entry points, reserve prices in auctions and unit cost allowances (UCAs) – Consultation Document, May 2005, 139/05

Warwick Energy is please to submit views and comments on the issues raised in the above consultation document. Our comments refer to the issues directly relating to our proposed storage project at Caythorpe as well as the UCA process in general.

The UK gas industry is about to go through a major transformation over the next few years the like of which has not been seen since the industry was liberalised. The UK will become reliant on sources of gas that are not dedicated to this market at the same time as the new entry flows are expected in the South and West of the system causing changes to existing flow patterns.

The implications of both of these changes need to be considered alongside the 2007 Price Control review to ensure that future structures are consistent and cost effective. We therefore strongly support a modified Option 2 followed by a comprehensive review to ensure that the arrangements post-2007 are 'fit for purpose' and cost effective.

Please do not hesitate to get in contact should you wish to obtain further information or views on any on the comments made.

Yours sincerely

Mark Petterson
Director

GAS TRANSMISSION – NEW NTS ENTRY POINTS, RESERVE PRICES IN AUCTIONS AND UNIT COST ALLOWANCES (UCA’S)

RESPONSE TO CONSULTATION DOCUMENT, MAY 2005

WARWICK ENERGY LIMITED

Warwick Energy Limited (WEL) is a developer of UK energy projects including gas production schemes, gas fired generation projects and gas storage projects. WEL is therefore interested in the general development of NGT’s system, for both entry and exit points, in an open, transparent, cost-effective and non-discriminatory way.

The main focus of our response to this consultation is quite naturally related to our proposed gas storage project at Caythorpe, and what impact any changes to the current regime may have on this project, but we have also looked at the issues raised in a wider context.

WEL recognises that modelling future system flows, especially over such long periods, is a very difficult and complex challenge. The number of uncertainties, particularly on the supply side, is very significant over the coming years and some reasonable changes to certain assumptions can dramatically change the outcomes from the models. It is therefore difficult to have much faith in the outcome of any such modelling at the moment even if we were in agreement with some of the base assumptions made – which, as you will see below, we are not.

The fundamental changes that will occur in the UK Gas Market over the next few years will alter the way that various parts of the system are used. In many cases however the extent of the changes are difficult to predict. WEL believes that neither the baseline flow assumptions nor the auction signals are accurate or sufficient to provide a picture of future usage patterns with any confidence. Alternative, interim, planning assumptions must be made until the new, more stable flow patterns appear.

As an example, WEL does not agree with the assumptions that the new import terminals will be utilised as predicted, as supplies (whether they be LNG, Norwegian or Russian) will often be directed, sometimes at short notice, to other international markets with higher price signals. The entry of the UK into a global gas market should raise Security of Supply issues (as the ultimate Consumer Protection issue) much further up Ofgem’s agenda. Consideration must be given to encouraging and supporting new investments, such as storage projects, that will help satisfy domestic demand and reduce price volatility.

WEL believes that the current Ofgem policy of treating all new NTS connections in the same way is wrong. The various benefits of storage schemes should be recognised and any system costs involved should be smeared across system users who will benefit from the additional security, reduction in volatility and lower prices that will result. WEL believes that all gas storage schemes should have a zero entry cost as a

maximum and that negative entry prices, as used in the UK power sector, should be considered to encourage new storage capacity further and to reflect, even in a crude way, the benefits that these schemes provide to NGT and all gas users.

In contrast to the views stated above the initial proposals from Ofgem threatened to add nearly 50% to the project costs for our Caythorpe scheme.

As stated in the document, WEL first notified NGT and Ofgem of its plans for the Caythorpe site in early 2004. At that time, and for around 12 months later, WEL assumed that conditions for this project to connect to the NTS would be broadly in line with other similar projects in the area. Only in the spring of 2005 did it become apparent that the remodelling activity initiated by Ofgem could threaten the project by possibly imposing much higher entry costs on this scheme than had hitherto been expected.

It will be seen from our comments below that we are strongly supportive of Option 2 (either as proposed or, ideally, as modified below). This is based not only on our natural interest in keeping the Caythorpe project economic but also for the wider and longer-term benefit of the gas network. We believe that adopting Option 1 would be a serious mistake as some of the assumptions used are, we believe, wrong and its adoption would lead to great uncertainty within the industry and would inevitably be followed by further substantial changes shortly afterwards.

As soon as WEL was made aware of what Ofgem was considering in this area we argued that any changes of the order indicated needed careful consideration and significant debate within the industry, in conjunction with the other major issues soon to be under consideration as part of the Transco Price Control review. Any changes need to be consistent with this review, the possible changes with the exit regime and an agreed, stable model for the system going forward. Major changes followed by further changes in short order could plunge the industry into confusion.

WEL has grouped its comments into certain main topics as shown below.

Long Term Auctions

The long-term auctions were expected to provide the industry with clear signals for future system flows. WEL agreed with this initiative at the time but the signals have not been as clear as expected and any likelihood of these signals improving over time has been torpedoed by the uncertainties that this review will raise. Questions must now be asked as to whether the industry should persist with this system at a time when the network is clearly in flux.

WEL believes that the auction process should be suspended until a full review is completed at which time signals for a more stabilised flow pattern may have emerged. An interim system for allowing new entry points would be needed, ideally allowing for separate arrangements for Storage projects than for pure entry-only schemes.

Even if our request for special consideration for storage projects is ignored, a move to a shallow reinforcement policy for entry points (as per exit points) is sensible.

Transco Capacities

It seems increasingly apparent that previous decisions and Price Controls have inadvertently allowed Transco to build a system with significantly more capacity than is required to cover their 1-in-20 obligations. The cost of this 'overbuild' has probably already been recovered from consumers. Continuation of the current regime for new entry points just further perpetuates this error and is not in the interests of consumers.

We suspect that few if any of the indicative reinforcement projects identified in Table 4.4 would actually be needed (let alone built) and may already be part of Transco's general reinforcement plans for the next period. Any imposition of additional costs as proposed may mean that consumers could end up paying twice for unnecessary reinforcement work.

Historically, significant reinforcement work has been agreed to allow increased flows from North to South in the UK as SNS supplies declined and deliveries at St Fergus increased. The new expected supplies at the Isle of Grain and at Milford Haven will reverse this trend and should effectively free up significant capacity. WEL finds it hard to believe that any further reinforcement is required for a system already over-built and where the principal flow path constraints are about to be relieved, especially given the modest flows identified for the Caythorpe and Star projects.

Baseline Assumption

The assumptions provided for the main entry flows for the UK do not seem to match the expected demand figures and contain some surprising assumptions. WEL believes that the only current data that may prove to be reasonably accurate in these uncertain times are the overall UK demand figures (although many feel that the 1-in-20 figures are somewhat high). There is a good historical trend line for this data and, with no major new gas-fired generation expected at the current gas prices, the possibility of significant increases in demand looks remote for at least the next 5 years.

How UK demand is satisfied at different times of the year from the growing number of entry points is very much open to question. In theory there could be an over-supply in the UK in forthcoming years but if that were ever likely to threaten it would be reflected in price signals that would drive supplies not dedicated to the UK market elsewhere, either through the interconnector or the redirection of LNG cargoes. This clearly happened to some extent with interconnector flows during the 2004/05 winter and the instances of 'unexpected' flow patterns will increase for modellers using UK-only data.

The data available clearly indicates that significant existing (and paid for) capacity lies stranded in the Transco network and that the current UCA process ignores this and allows Transco to keep building (and charging) for network enlargement. These costs are ultimately borne by the consumer.

WEL believes that the baseline flow assumptions need a thorough, pragmatic overhaul and the impact of a number of scenarios needs to be assessed.

A range of models should be used to check the outcomes but the biggest concern must be to get a consistent and sensible set of assumptions with which to populate these models. If, as we suspect, a range of assumptions is needed then probabilistic modelling should be used to provide a balanced result. The models and their assumptions should be made available to all sectors of the industry and UCA's should be checked, and possibly reset, each year.

Model Assumptions – Errors

In addition to the problems with the baseline data above, the modelling assumes that any new entry flows results in increased demand (thereby triggering reinforcement) – called load absorption - rather than the far more sensible substitution assumption. The load absorption assumption seems totally illogical to us and must be corrected if the industry is ever going to get a cost-effective and fit for purpose system. This error is one of the main causes of the strange results coming from the recent modelling.

The 1-in-20 demand forecast predictions already factor in some reasonable assumptions on load growth. There is no reason to presume that demand will grow above this trend and there is increasing concern in the industry that the '1-in-20' assumptions to predict peak demand may themselves need revisiting in light of global warming and recent winter outturns.

The advent of a new storage scheme will not trigger an increase in demand in the UK market, it will only increase the options (and security) as to how this demand is satisfied. Clearly the entry and exit volumes in a model have to balance but the sensible way of modelling the effect of a new storage scheme is to run a series of sensitivities to model these new flows substituting for existing predicted flows at one or more of the other entry points.

As the system is already overbuilt, it is predicted that this more logical approach to modelling the (modest) flows from the proposed storage schemes will correctly identify that no additional reinforcement work is required.

Model Assumptions – Inconsistencies

The different treatments concerning investments to support entry and exit capacity seem illogical. We propose that both systems should only be subject to shallow reinforcement considerations given the significant uncertainty over actual future flow patterns. Any remaining costs should be commoditised. The assumptions that all agreed system costs are not eventually reflected in end-user prices is naïve and the false allocation of some of these 'general' system costs to individual projects threatens much-needed new storage capacity.

Security of Supply

Whilst Security of Supply is not explicitly stated as an objective for Ofgem in its licence it must be the most important issue for the protecting the interests of the consumer. Without secure access to gas, particularly in peak winter conditions, many of the other 'softer' consumer protection initiatives (where much money is spent and cross-subsidies exist) are very much second order.

WEL believes that, as Britain enters the new era of import dependency, Ofgem should re-examine its priorities in this area and accept that certain investments (such as new storage projects) benefit the system and all of its users. Such assets should attract either zero or negative costings to reflect these benefits irrespective of any deep system reinforcement costs that may be identified. This is a model generally accepted in the UK power sector (in broad terms) and we believe that the constraint in the Transcost model (that prevents any negative entry costs) is wrong.

Storage in General

Apart from the issue of Security of Supply as mentioned above, WEL believes that storage capacity provides the system and the gas market with much needed flexibility. It is in the best interests of the entire market that more investment in gas storage is encouraged by attempting to reflect these benefits (crudely if necessary) in the charges allocated to these sites.

The additional flexibility offered by these new facilities will help to dampen price volatility, to the benefit of both Transco and consumers, and will also normally act in a supportive way to help Transco balance their system at least cost. The current system allows Transco to benefit from their reduced balancing activities (and costs), in both summer and winter, for free.

The unintended consequence of the current charging system is to penalise, rather than encourage, the types of new investment that the industry will increasingly need.

WEL recognise that this is a particularly difficult area to model with any precision as the reality is that the use of storage capacity is not directly linked to system volumes but to system prices. Whilst entry capacity at storage sites is likely to be used under peak system flow conditions, this is not definite and peak prices are, on many occasions, triggered by other events such as constraints offshore or at beach terminals.

Another area where Storage is a special case is the lifetime over which it is reasonable to assume that any costs should be recovered. The 10 year period currently assumed is possibly not unreasonable for normal entry points, where contracts and field depletion durations are of this order, but storage projects are designed for much longer lifespans. Recovery of entry costs should be assumed over a 25 to 40 year period to avoid an over-recovery by Transco over the project life.

Summary

WEL believes a fundamental review of the UCA process is required alongside the 2007 Price Control (and any changes to the exit regime) and that the main auction process should probably be suspended in the meantime. Interim measures are required to allow new storage capacity to be built and we believe that the entry costs for these facilities should be set at no more than zero because;

- correct modelling, using an assumption of flow substitution rather than load absorption, will show that no system reinforcements are required for the four schemes in this consultation document
- entry points should only be assessed under shallow reinforcement criteria and any general system reinforcement should be smeared
- a proactive strategy of encouraging new storage capacity should be pursued in the interest of all UK gas consumers

Of the two options indicated in this consultation document WEL strongly supports Option 2 with the modification to the pricing terms stated above.

If there is concern that the 2007 review may ultimately result in significantly higher prices for these new storage sites (a view that we would not share) then a constraint on the period over which capacity could be booked to around 10 years might be acceptable. The funders of such schemes would typically look to us to provide commercial certainty over at least a 10 year period.

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