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TPCR Consultation December 2005

Mr Robert Hull
Director Transmission
Office Of Gas and Electricity Markets
9 Millbank
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Dear Bob,

ExxonMobil International Limited is responding to this consultation on behalf of its gas shipping entity ExxonMobil Gas Marketing Europe Limited.

General

Ofgem has considered a wide range of options for potential change in this consultation and whilst we fully support the requirement to consider options we hope that changes will in fact be limited to those areas where it is clear that current arrangements are not working. The case for change must be clearly established and care should be taken to anticipate fully all potential consequences of new arrangements.

In the case of gas entry arrangements, we consider that changes may be justifiable in four areas:

(i) Separation of charging (reserve prices) from revenue drivers (UCA).
(ii) New, enhanced NGG incentives to ensure new infrastructure is provided on a timely basis consistent with capacity rights allocated
(iii) Economic losses incurred by shippers as a result of NGG failing to provide capacity rights allocated should be compensated.
(iv) The basis on which baseline capacity at entry is defined

Response To Consultation Questions

Our additional views are provided after relevant consultation question or set of questions. We only address responses to gas related questions that are relevant in the areas we believe change is likely to be justifiable.

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Cost Assessment (Questions on page 26)

Q: How should Ofgem assess the need for additional capital expenditure allowances to provide flexibility in the availability of network capacity in advance of firm demands for capacity by network users? What, if any, reasons might there be for consumers placing a higher (or lower) value on such network flexibility over the next price control period as compared to the current (or past) price control periods?

It is our view that Ofgem can allow NGG increased ability to commit capital expenditures so that it can efficiently respond to shippers requirements for capacity flexibility. To the extent that no user commitments are made in support of capital spend, however, Ofgem should retain some ability to make ex post adjustments to capital allowances; this will ensure that NGG sees an incentive for sound capital performance and decision making. This may essentially mirror current arrangements in which case we see little room for change.

Where capital expenditure is justified and supported by defined minimum user commitments, Ofgem should not retain any scope to arbitrarily limit capital expenditure allowances. To the extent that firm capacity rights have been allocated based on commitments made, the network should be constructed to be materially capable of delivering this capacity. To the extent that no commitments are made in support of new infrastructure, capex allowance can be properly refused on the grounds that it may be speculative.

Q: Do respondents agree that Ofgem's focus on 'user commitment' options is appropriate, or whether they consider that there are other traditional price control options (or de-regulated revenue options) that might better meet Ofgem's objectives for the TPCR, particularly in the context of the Authority's statutory and other legal duties?

Fundamentally we support a "User Commitment" model where new investment is concerned. Equally fundamentally, we believe the system of regulated common carriage arrangements in GB should be maintained; such arrangements provide the opportunity for all parties to influence developments in both the NGG licence and the Code; Ofgem has the final decision in determining what amendments or modifications are implemented, and it is wholly appropriate that the consequence of any failures or shortcomings in implementation is one that has to be shared by all parties using the network.

Q: What is the appropriate allocation of investment risk between network users (both generally and at specific locations), transmission companies, and consumers, during the different phases of investment development, e.g. planning and design, construction, and operation?

Investment risk is a shared risk consistent with the principles of common carriage. The regulatory framework must allow the possibility for minimisation of risk prior to each new investment decision, and enable lessons from each earlier investment to be reflected prior to each subsequent decision. We see that it is particularly important that NGG are provided with all necessary tools to perform as "best in class" in relation to planning, design, procurement, construction and operation. Capital and operating cost allowances have therefore to be designed to enable best in class performance in these respects and in particular should promote the use of first class service providers. We look to Ofgem to ensure that NGG's

procurement processes are fully adequate and include appropriate financial incentives for contractor performance. Finally, we look to Ofgem to identify and encourage areas where achievement of expected performance standards can be assisted through project to project (bilateral) arrangements which are flexible to be able to include such financial incentives.

Q: Is it appropriate to seek to separate, both formally and operationally, the issue of how charging and reserve prices are set at gas entry from the issue of how incremental revenues are determined under the price control?

Yes, it is appropriate to consider the possibility of separation. Such a change, with the right structure, may provide a more market dynamic or responsive network in terms of investment and operational planning. Ofgem is clearly aware that such separation could provide NGG with increased project and operating freedoms, and it would therefore need to be sure that the transfer of decision ownership was in consumers' interests and would not wreck the community's wider interests of stability and certainty. Detailed consultation on the charging methodology accompanying such a separation is most important and the result must be seen as capable of meeting the stability criteria.

Revenue Drivers For Entry (and Offtake)

Q1 Should the revenue driver be nodal, zonal/locational or global? What are the advantages and disadvantages of these different options – and to what extent do these advantages and disadvantages differ between entry and offtake? If a zonal approach is preferred, then how might zones be defined?

Q2 What are the key cost drivers of incremental capacity – and how might these vary between entry and offtake? How should these be quantified ?

Q3 Should revenue drivers be fixed for the price control period or should they be adjusted during the price control period?

Choosing between nodal, zonal, global drivers relies in the first place on whether revenue drivers should be separated from charging methodology.

It is not clear how a global revenue driver can be easily considered without assuming in the first place that separation of revenue driver from pricing is justified. At this stage it seems to us that a global revenue driver might offer a key benefit of enabling Ofgem not to place arbitrary regulatory limits on Users' locational choices. Of course Ofgem would need to consider what restrictions might be required so that NGG always sees the incentive to keep Users properly and accurately informed of locations on the network where connection and/or reinforcement would result in more efficient transmission investment. An arrangement that would allow revenue driver(s) to remain fixed for the duration of the price control (or beyond) would of course be preferable.

Entry capacity baselines

Q1 Should the baseline be a measure of capacity and if so, should it reflect the level of existing capacity or the level of anticipated capacity?

Q2 For revenue restriction purposes should the baseline be set 'flat' for the five years of the price control period or should it incorporate growth (or decline)?

Q3 Should the baseline be set on an entry point specific, zonal or network wide basis or should no ex ante baseline be defined? What are the advantages and disadvantages of the different options ?

The baseline should be a measure of capacity and should reflect at least the level of firm capacity rights already allocated. The baseline, on the minimum possible definition, must be variable to reflect existing auction signals (allocated capacity rights) over the five years of the control. This element of baseline capacity must be ex ante and not at risk of any redefinition. These minimum baseline components have to be entry specific as they have been sold on this basis.

A key benefit of the current approach to baseline definition, as Ofgem rightly points out, is that it is an objective measure of unconstrained installed capacity at each entry point; it ensures that there are no arbitrary restrictions on the amount of gas that might be offered to the competitive market for sale on a day. On the other hand, a disadvantage of the scheme, increasingly evident from NGG and other industry forecasts, is that utilization levels at a number of existing entry points is forecast to decline quickly over the course of this next price control. Without any adaptation of the current regime, this will likely have the effect of undermining the value of firm capacity rights already allocated at such entry points; perhaps more importantly from the market perspective it will weaken rather than strengthen longer term supply signals and create additional uncertainty. Given this it would seem to us that on stability and security grounds there are arguments to consider baseline capacity definition that allows rational reductions at some entry points.

It should be possible to identify capacity for which there is no clear supply signal and "mothballing" this to help identify efficient level of operating costs and providing rules by which such capacity might be reinstated i.e. on evidence of clear user commitment. It also seems worth exploring whether entry capacity at a "long" location could be reduced and added to another "short" location, even if not on a 1:1 basis.

Another approach could be to define the integrated capacity of the network in a wholly different way: e.g. by allocating capacity in terms of components (a) assignable to individual entry points not substitutable and at least at the level of allocated firm rights, (b) assignable to zones for that part of capacity that is switchable between a limited number of entry points and (c) assignable to common entry capacity when fully transferable between any entry point. Such an allocation could lead to an operating platform that is more dynamic and responsive to market choices on gas landing points. On the other hand such an approach may lead to a very complex scheme, and less rather than more transparency. Care will be needed to avoid development of a scheme that is unusable for the purposes intended.

It would also seem rational to establish an aggregate limit to baseline capacity set at the 1 in 20 demand level but which could always be increased above that level by additional User commitments. We fully support Ofgem further exploring the possible schemes, keeping in mind a requirement for objectivity, simplicity and transparency.

Buy back incentives for entry and offtake

Q1 Would it be appropriate to treat buy backs from operational constraints differently compared with buy-backs resulting from delayed investment for incremental capacity? If so, should there be two different buy-back mechanisms and what would the advantages and disadvantages be? How could we distinguish between the two types of constraints?

Q2 Should the existing buy back incentive be refined to ensure an appropriate allocation and management of risk or should a different type of buy back incentive be considered, and if so, what form might this take?

Q3 Should delay to incremental investment due to connecting pipelines be included in the buy back incentive?

Q4 How should risks be allocated between shippers, National Grid Gas and consumers?

At Ofgem's "Incentives"seminar on 20 October 2005 we explained our view that it was in the interest of all parties to ensure the timely delivery of new pipeline projects, on which GB may increasingly depend for new gas supplies. Maintaining a reputation of success with external investors and avoiding potential costs to investors, shippers and consumers for failures to provide capacity consistent with allocated firm rights has to be established as a firm objective for NGG. In that respect we would support significantly enhanced incentives on NGG to ensure that new pipeline projects due to be completed in the next price control are completed on time. That is, the regulatory structure must provide emphasis on getting it right at the front end rather than having to deal with the consequences of a significant constraint later on. We acknowledge that efforts have already been made in relation to assessing realistic construction lead times to reduce such risk and it is our clear view that the Transmission Operator should be subject to enhanced performance measures given the potential costs to consumers that may be associated with significant constraints.

Turning to capacity constraints, we believe that smaller day to day operating constraints should continue to be managed via a market based buyback scheme allowing affected shippers to bid for compensation at the level of its economic loss. We see little evidence to suggest that these arrangements require significant change.

For larger constraints, related to investment delays, a case by case treatment is preferred. A review may be triggered by Ofgem if or when it becomes clear that both delays and an economic loss might actually arise. Ofgem should consult on and provide a framework of principles on which it would conduct such a review and how it would proceed to evaluate economic loss including the extent to which such losses had been or could have been mitigated. The framework would also need to describe how it would approach sharing of such losses between shippers and NGG consistent with the common carriage precedents and establishment of cause. The main advantage of this approach is that it does not rely on a competitive process to establish costs where there may be limited competition; it would be capable of providing all relevant investors with the necessary assurances of fair treatment to enable them to proceed with their developments ; it would ensure that the attraction of GB as an investment location remained strong.

Q5 Would it be desirable for the regulatory regime to enable more flexible contractual arrangements between shippers and National Grid Gas (for example in relation to construction scope)? How might this achieved? What would the advantages and disadvantages be, especially how might this impact on consumers?

We have already addressed this in our answer above under the heading Costs Assessment

Interactions between entry and offtake options

Q:What are the main interactions between entry and offtake, and how does this affect the approach to baselines, revenue drivers and buy-back mechanisms ?

Q:Should the same approach to baselines and the revenue driver be adopted for entry and offtake? What would be the advantages and disadvantages of doing so?

Q: Should there be one buy-back incentive covering both entry and offtake ?

The interactions between entry and offtake depend on the design of the network, the distribution of supply and demand (operating configuration) on a day or period, and the basis on which network capacity is allocated between entry and exit. The interactions are complex.

At a high level there is some logic in taking the same approach to baselines for both entry and offtake as transmission costs are recoverable from each on a 50:50 basis - an arrangement that we see as important to continue since any other basis for recovering costs would undoubtedly be arbitrary in an entry exit regime.

The revenue drivers for investment (capacity) will be related to unit project and construction costs, and the unit costs of materials required in construction. These should not be materially different for capacity additions at entry or exit assuming they are struck to reflect the relevant materials markets and environmental factors that may affect pipeline or compression construction.

For operational constraints we could see that offtake and entry buyback arrangements may be combined under a single structure.

Please do not hesitate to contact us if anything in this response is unclear to you, otherwise we trust that our views will be taken into account.

Yours sincerely,

Ian Trickle
Europe Regulatory Advisor