UKOOA
oil and gas for britain

3rd Party Proposal: Publication of Near to Real Time Data at UK Sub-Terminals: Modification Proposal UNC 006 Impact Assessment 22/06, 3rd February 2006

Introduction and Summary

UKOOA welcomes the opportunity to respond to Ofgem's Impact Assessment published on 3rd February 2006 regarding UNC modification 006.

UKOOA has studied the IA carefully, but has concluded that, overall, it is wholly inadequate as an assessment of the full, likely impact of UNC 006 being approved. Even within its own terms, the analysis is unsatisfactory. As was the case with the original IA of May 2005, this new IA addresses the effects of this modification proposal downstream, but does not appear to have taken proper account of the damage which could result in the upstream sector, particularly to the investment climate. We have drawn attention to this before and we would urge Ofgem to consult DTI and take this important point into its calculations and considerations, before reaching a final decision.

- **UKOOA supports the increased provision of information to the market, provided that such information does not prejudice the commercial position of individual companies, a point which was accepted by all parties, including Ofgem, to the discussions chaired by DTI in 2003-4 which led to the three phase information release scheme.**

- **However, approval of UNC 006 would risk exposing a number of offshore fields and several new import flows to the market in this way, following a supply failure. It was for this reason that it had also been agreed that certain data in phase three of DTI's scheme should only be published in aggregated form. The justification for this remains as valid today as it was when it was originally made.**

- **It would appear that not enough consideration has been given to the potential consequences upstream of implementing UNC 006, particularly regarding the investment climate, upon which future production of the UK's gas (and oil) depends. This has serious implications for the security of national energy supplies.**

- **It is difficult to discern within the IA from where the underpinning assumptions have been derived. Oxera has done some further analysis for UKOOA and has also come to this conclusion (we attach Oxera's short report, for information): *"…., on the available information, the approach is unlikely to be robust or an appropriate representation of the impact of additional information release."* UKOOA agrees.**

- **The claimed benefits from "system balancing" which have been carried forward from the earlier IA are predicated on a condition which will not be satisfied by UNC 006 and so are not realisable.**

- **Even if the other benefits calculated in the IA were to materialise, about which UKOOA has considerable doubts, they are NPVs over 15 years and would be extremely small when set alongside the value of the gas flowing through the NTS or the effects of recent fluctuations in prices at the NBP. Should such benefits exist, they could, in UKOOA's view, easily be outweighed by dis-benefits in the parts of the gas market not covered by the IA, to the overall detriment of consumers.**

- **As a result of these points above, the true value of UNC 006 has to be highly questionable.**

- **Current difficulties in the market are primarily being caused by an insufficient supply of gas to meet demand, at an affordable price, allied to effects created by the differences between the UK's and mainland Europe's markets.**

- **There are significant risks that UNC 006 will increase volatility in the market and, if there are any distributional benefits arising, they may well not be from producers to consumers, but from producers and consumers to traders (ref Oxera).**

- **UKOOA does not believe that the benefits of DTI's three phase scheme have been fully assessed and allowed for in the IA. It has not even been possible to assess the benefits over a whole winter which would surely be prudent. Therefore, we suggest that a review of the scheme is called for, once a whole year has elapsed since the introduction of all of its phases (see below).**

<u>**Comments regarding the Impact Assessment**</u>

1. We note that, in the IA's Summary, the proposal would apply to *"sub-terminals flowing gas above 10mcm/day".* As we have advised before, there are some eight offshore fields which can meet or exceed this rate of production. Several new import projects will be able to do the same.

   Therefore, a significant risk remains that individual company's confidential positions will be exposed to the market place by UNC 006, in the event of a supply failure. This would be both prejudicial to such a company's interests and contrary to Ofgem's previously stated position in its Guidelines of June 2005 and various letters in 2003 and 2004, and to the agreement reached in the DTI chaired talks[1].

[1] The four parties who took part in these talks during the winter of 2003-4 were DTI (in the chair), Ofgem, Transco (now National Grid Gas) and UKOOA. The talks led to the three phase agreement on release of information: Phase I was agreed in November 2003 and Phases II and III in March 2004.

Indeed, the Chairman of Ofgem, Sir John Mogg is quoted in DTI's press release of 6th November 2003, at the conclusion of phase one of DTI's scheme, as follows: *"This is vital information and I welcome the progress made. I hope that work will continue to release aggregated information to the wider market* [phase three]*, while of course safeguarding the legitimate concerns of the offshore industry. Actions such as this will further protect security of supply and minimise the effects of gas supply interruptions."* Approval of UNC 006 would, in our opinion, be inconsistent with that statement.

Interestingly, some consumer interests have advised UKOOA that they agree that exposure of an individual company to the market in the above way should not happen. It is also clear to UKOOA that different interests are seeking different outcomes, i.e. there is no single, coherent view of what the market would like by way of further information disclosure.

UKOOA was also pleased to note the public statements of support for DTI's three phase scheme by Ofgem's chief executive, Alistair Buchanan, in a speech to the Westminster Energy Forum in November 2005 and in a letter to The Independent, published on 8th March 2006.

2. The cost-benefit tabulation does not appear to consider any adverse effects on the upstream oil and gas sector and, in particular, the risks of damaging the investment climate for the UK Continental Shelf (UKCS). Currently, gas (and oil) production from the UKCS is (are) declining at a rate of about 7% per year. Without the present scale of investment (nearly £5bn in 2005, the largest of any industrial sector in the UK), production would be declining at twice this rate.

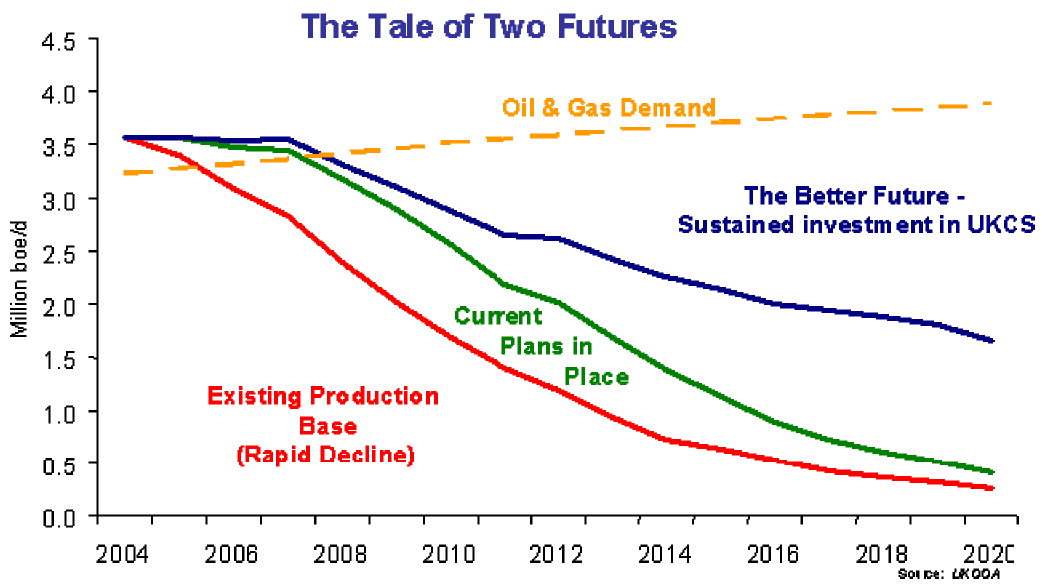
   Sustaining UKCS investment is thus fundamental to the achievement of the government's objectives of
   i) ensuring maximum economic recovery of oil and gas reserves from the UKCS and
   ii) securing the UK's energy supplies, gas being the largest source of primary energy in the economy (ref also Ofgem's statutory responsibilities on p.28 of the IA).

   Any reduction in oil and gas investment and, as a result, a more rapid decline in UKCS production would have consequences far exceeding the possible benefits of UNC 006.

   Investors will always consider the range of risks which they may face: technical, commercial, financial, fiscal, political and regulatory. As we stated in our response to the original IA: *"…, it is impossible to imagine that the decision to invest in, say, the Ormen Lange field and the Langeled pipeline would have been positively swayed by possession of such detailed knowledge* [UNC 006 information]*. However, it is entirely plausible that an adverse effect would be created by UNC 006, if the investing participants believe that their commercial positions would be exposed to other participants within the market, as well they may now do."*

International investors have a choice of where to invest. Norway, for example, can choose whether to sell its gas in the UK or in mainland Europe. There are numerous other oil and gas provinces worldwide with better prospectivity and lower costs than the UKCS (ref Wood Mackenzie's study published in November 2004) which are attracting international funds. For several years, DTI and the upstream oil and gas industry have been working closely together, under the auspices of PILOT, to improve the investment climate here, encouraging new companies to bring their methods and technology to the UKCS and removing barriers to fresh investment by both new and established businesses alike. Without all of this, objectives (i) and (ii) above would be put in some jeopardy.

We show below a graph about the future of the UKCS which demonstrates the imperative of sustaining investment; DTI has used it on page 33 of the energy review consultation, in a section titled "Reliable Energy Supplies – Making the Most of UK Oil and Gas Reserves".



It is, therefore, UKOOA's view that the effect of UNC 006 on the upstream sector would give rise to the un-necessary risk of a material reduction in investment in the UKCS, a risk that would be best avoided.

3. In any event, UKOOA considers that the claimed benefits of UNC 006 are not well substantiated. We refer to a short, new report for UKOOA by Oxera[2] which we have attached for Ofgem's information. In this report, Oxera raises doubts about the analysis regarding "economic signals" and, in particular, the assumptions underlying the analysis. Oxera points out, for example, that *"beach, storage and interconnector flows are likely to be strongly related"* to one another, although Ofgem assumes otherwise in

[2] Oxera undertook a cost-benefit analysis for UKOOA of near to real time information, in May 2005, which UKOOA forwarded to Ofgem and DTI and published on its web-site.

paragraph 2.13 of the IA. Also, Ofgem has assumed that gas prices at Zeebrugge are independent of the other variables listed, but Oxera notes that these *"will be closely related to interconnector flows".*

Furthermore, in paragraph 2.16, it is difficult to know from the information presented how Ofgem has derived its assumptions about beach coefficients: *"There is no evidence presented to suggest that statistical tests have been undertaken to determine whether the value of the coefficient associated with beach flows is statistically different from zero"* [ref Oxera]. And on the subject of causality, Oxera observes that *"Further problems may arise, as gas prices in the UK may affect prices in Zeebrugge, instead of prices in Zeebrugge affecting UK prices, as implied by Ofgem's (2006) regression."*

These points and others like them in Oxera's report (e.g. *"there is no explanation of the nature of the relationship between information release and the level of risk premium that has been assumed"*) strongly suggest that the analysis presented in the IA cannot properly substantiate the benefits which have been calculated.

4. Regarding the other economic benefits, these appear to be carried forward from Ofgem's earlier IA of May 2005 ("System Balancing of £25.03 million" and "Market Volatility of >£38.05 million", both NPVs over 15 years, previously £2.5m and >£3.8m per year).

   However, as we pointed out before in our response of 24th June 2005 to the earlier IA, the system balancing benefit of £25.03 million cannot be realised by UNC 006, because it is predicated on the market being *"informed in real time of the magnitude and expected duration of any offshore outage"* – ref paragraphs 5.49 and 5.52 in the IA of May 2005. UNC 006 would not provide such information and so UKOOA is unable to see how this benefit of £25.03m can be ascribed to the proposal.

   Interestingly, Oxera has identified that, if there are any distributional benefits with UNC 006, they may well not be from producers to consumers, as Ofgem implies in its IA, but from producers and consumers to traders.

5. In addition, it is noteworthy that, although the cost-benefit calculation appears to produce significantly favourable outcomes, these are NPVs over 15 years. By contrast, the value of the gas flowing annually though the NTS is of the order of £10bn. Therefore, even if the calculations are correct (a most unlikely eventuality, in UKOOA's view, given the points above), the real benefit to market participants of UNC 006 in terms of better value is going to be extremely small indeed.

   Such NPVs over 15 years would also be very small when set alongside the effects of the fluctuations seen during the past 2 years, as prices at the NBP have responded to variations in the supply-demand balance and the market's perceptions thereof (ref Heren's daily reports).

6. In paragraphs 2.4 and 2.5, Ofgem sets out the baseline for the IA analysis. However, there appears to be no clear assessment of the benefits of DTI's three phase scheme which only came into full effect in mid-2005.

   Furthermore, in 2.4 of the IA, it is stated that *"When Ofgem carried out and published its May IA, sub-terminal data was not made available to the market in any form."* This cannot be correct, because item 4 of phase three of DTI's scheme has provided sub-terminal data at D+2 to the market since October 2004 (and, before then, all shippers were supplied with this information).

   It is also worth noting that the updated and much more usable presentation of market information on National Grid's web-site did not begin until mid-November 2005. As a result, it is even less clear how the benefits of phase three can have been fully considered within the IA, given so short a time frame.

   The IA refers in this context to *"a particularly difficult winter"*, but there is nothing to indicate how this factor has been incorporated into the assessment. As UKOOA has stated before, it surely needs at least a complete winter and, preferably, a whole year before the benefits of phase three of DTI's scheme can be properly assessed (please refer to our proposal at the end of this response).

7. This winter's difficulties have primarily been caused by an insufficient supply of gas to meet normal demand, at prices which are affordable, not by insufficient information which, in the case of UNC 006, is so short term in its nature that it is extremely difficult to conceive how it would have significantly alleviated matters for those buyers who were priced out of the market during the current winter.

   Furthermore, this winter and the short period in late February and early March last winter have highlighted how the fundamental differences between the market in the UK and the one in mainland Europe are affecting the supply-demand balance and, therefore, prices at the NBP. The difference between UNC 006 and existing information, i.e. item 1 of phase three of DTI's scheme, would have no effect at all on this.

   Importantly also, the market balances over a 24 hour period and does so nationally. There already exist separate mechanisms for NGG to signal locational issues requiring gas at specific terminals. In the difficulties which arose in June 2003, it is worth recalling that locational requests at Bacton by NGG produced no extra gas and that NGG chose not to use LNG stored at Grain which would almost certainly have resolved the short term supply difficulty in South-East England, but resorted instead to interruptions.

8. We were interested to read in 2.55 – 2.57 Ofgem's thoughts about how producers can manage their own risks of production shortfalls, including

the suggestion that some production be held back in reserve. Long term contracts account for 65-70% of UKCS production and, during the winter, there is sufficient demand to require all available production from the UKCS. It therefore follows that Ofgem's line of thinking is likely to cause more gas to be traded in the short term and less gas to be made available in the forward or contract markets which will only serve to increase market volatility and disadvantage end consumers, especially in the heavy industrial and power generation sectors. In section 3 of its new report for UKOOA, Oxera discusses the potential for greater volatility in market prices.

9. UKOOA has long supported the increased provision of information to assist the functioning of the market place, provided that it is done in a balanced manner which recognises that information which could prejudice the commercial position of individual companies should not be published. UKOOA understood that this principle was accepted by both DTI and Ofgem during the 2003-4 discussions leading to the three phase information scheme. For this reason, it was agreed by all four parties to those discussions that certain data in phase three should only be published in aggregated form.

   This question of a reasonable balance was central to the three phase agreement in 2003-4. If UNC 006 were to be adopted, it seems inevitable that there could be some risk of a reduction in the flow of information to the market. However, Ofgem considers this risk to be small and so has not put a value on it. For its part, UKOOA will continue to support better provision of market information, provided that commercial confidentiality is respected, as identified above and in our previous responses on this subject.

10. Regarding contract negotiation and liability, we wrote in our response of 24th June 2005 to last May's IA: "*It is almost impossible to estimate the magnitude of the costs which would arise, because no one knows how many contracts would have to be renegotiated (or would be willingly renegotiated) or of the consequences of any breaches of confidentiality. We suggest that the implications contained in 5.88 and 5.90 would need to be carefully considered case by case.*

    "UKOOA simply points out that a) it expects all contracts to be honoured whether they are existing or amended contracts, b) some parties may be willing to renegotiate, but some may not, c) it agrees with Transco that any renegotiation is likely to be protracted and d) should liability risks for breaches of confidentiality crystallise, even if that is an unlikely event, these will probably involve substantial sums far in excess of the estimated annual benefits of UNC 006."

    We have seen no reason to change our opinion, nor do we consider that paragraphs 2.63 – 2.65 of the new IA adequately take these matters into account.

11. Ofgem has compared the gas and electricity markets and stated that *"….. in electricity, information is made available in real time ……… and, where an outage occurs, the commercial positions of affected parties will be exposed."* UKOOA's understanding, however, is that, because of the gate closure procedure and a half hourly balancing period, such exposure for electricity generators is much more limited than is the case in the gas market which balances over a 24 hour period. As we demonstrated in our response of 11th November 2005, an affected *"company is faced with a direct cost which will soon be measured in many £millions".*

    Therefore, we do not believe that it is valid to make this comparison between electricity and gas. Also, as we have noted before, there is no equivalent in electricity generation of the risk of reservoir performance (with, perhaps, the exception of nuclear power) and, offshore, the weather and marine environment add other dimensions to production risks which are almost entirely unknown onshore.

<u>Questions 1 – 8</u>

Q1-4. With respect to questions 1 to 4, UKOOA has pointed to a variety shortcomings in the IA in our comments above.

Q5. It is not clear to UKOOA what value January's consultation had, given its inherent weaknesses (ref our letter of 16th January 2006).

Q6-7. NGG's estimates are probably reasonable, assuming that the amount of work required to implement UNC 006 is the minimum. However, should it transpire that there is considerable work to be done, e.g. installing new or duplicate metering, or substantially upgrading data collection and processing systems, then it is unlikely that the estimates are adequate or the programme for implementation realisable. These possibilities do not appear to have been properly considered in the IA.

Q8. Please refer to our comments above.

<u>Conclusion and Proposal</u>

UKOOA remains convinced that modification proposal UNC 006 will have adverse effects on the upstream oil and gas production industry which have not been fully assessed in the IA, particularly regarding the risks to future investment, with the serious implications which this will have for security of energy supplies. Oxera's new work for UKOOA clearly casts considerable doubts on the analysis supporting this IA and the claimed "system balancing" benefits, brought forward from May 2005, cannot be realised by this modification. Even if UNC 006 were to be implemented, we believe that its true value to market participants will, at best, be extremely small and possibly even outweighed by the dis-benefits.

We therefore propose that, rather than implement UNC 006, it would be better to undertake a thorough review among all participants, including DTI, of the full benefits of the three phase scheme, once a whole year has elapsed, namely from July 2006. This would also provide an opportunity for all parties to discuss and understand the aspirations of others and, perhaps, provide a means of reconciling some of the differing views.

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