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Dear Bob

**BG Gas Services Limited Response to Transmission Price Control review 2007 - 2012. Third Consultation.**

BG Gas Services Limited ("BG") welcomes the opportunity to respond to Ofgem's third consultation on the Transmission Price Control. BG is active in the UK market as a gas shipper, marketing and trading gas on behalf of BG Group's UKCS production activities. In addition BG Group has both equity interests and capacity rights in the Dragon LNG terminal currently under construction at Milford Haven in south Wales. Our comments therefore focus on the Price Control for National Grid Gas' transmission activities, with emphasis on the gas entry incentives.

**Summary**

- BG has major concerns over Ofgem giving NGG discretion over capacity release. It is essential that respondents can comment fully on the proposed NGG methodology and network model, before decisions are made fundamentally changing the regime..
- BG does not consider it appropriate that shippers are given the sole role of policing NGG's capacity release.
- BG considers that the existing Buyback Incentive should be toughened up if Ofgem's concepts on capacity release are implemented.
- BG considers that Buyback proposals for future New Entry points could be workable provided the rules are set out clearly in advance.

**General Comments.**

As Ofgem have pointed out, the proposals relating to gas entry represent a fundamental change from the current Price Control arrangements. Gas entry arrangements were the subject of considerable debate at the time of the last Price Control Review, and it is disappointing that the industry is facing major change after only 5 years of the current regime with all that means for regulatory stability and uncertainty. However, if a stable and sustainable regime is achieved, such difficulties will be worthwhile. To ensure that a sustainable regime is achieved, BG welcomes Ofgem's efforts at consultation to date. In answer to the question Ofgem raised at the Seminar on 19<sup>th</sup> April we believe further workshops will be essential. In particular there should be increased emphasis on how proposals will work in practice, and how the proposals will impact current bookings of

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capacity etc, given that a number of shippers will have made long term commitments in the expectation of a stable regulatory regime. BG recognises that such a process is onerous, but believes this is one way to ensure that improved understanding minimises the potential for unintended consequences.

#### **Form and structure of the Price Control.**

*Question 2.5. Should the current form and scope of the System Operator (SO) incentive schemes be adopted in the next price control period?*

BG will respond to your SO Incentives consultation when it is published. We would note that the incentive to date has been relatively benign to NGG. Whilst not a major issue, Ofgem may wish to consider the effectiveness of the current dual price and line-pack daily balancing incentive. Following the market each day, we sometimes wonder if this leads NGG to follow the right balancing actions, particularly with respect to timing.

*Question 2.6. To what extent should incentives applying to the Transmission Owner (TO) costs and SO internal costs be equalised? Should these costs (e.g. staff costs and IT spend) form part of the TO price control?*

BG agree that NGG should be incentivised to managed costs efficiently across the TO and SO activities.

#### **Gas Entry Incentives.**

*Question 4.1. Do you agree with Ofgem's plans to change the nature of NGG NTS' licence obligations to release entry capacity? What particular measures are needed to ensure that the regime is transparent, and ensure against capacity being held back unnecessarily?*

BG agrees with the need to ensure that the NGG network responds appropriately to the need for new capacity, and to avoid sterilisation of capacity between different entry points. It is encouraging that, based on the analysis in Appendix 10, NGG believe they may be able to amend the network configuration to provide increased capacity where there are demand signals. However a workshop to run through NGG's model and the proposed methodology is essential to provide greater clarity for shippers. Without this is difficult for BG to support the proposed changes.

BG has concerns with Ofgem's proposed approach, both on grounds of necessity, and on grounds of the method of implementation.

Firstly it is not clear that a wholesale move away from the baseline approach is necessary to solve the problems identified by Ofgem. The advantages of the baseline approach are that it avoids any problems of under supply of capacity by a monopoly provider. When the baseline approach was introduced in 2002 it was a response to the under supply of capacity by Transco at various entry points such as St Fergus in the previous Price Control. This had resulted in a significant over-recovery of revenue by Transco which then had distortionary effects when the over-recovery was returned to certain groups of shippers only. When the baselines were set in 2002 one of the potential disadvantages identified was that they were set too high, being based on the theory that all flows were to be subordinated to the terminal in question for the calculation of the baseline. Such an approach obviously runs the risk of under-recovery for NGG (although NGG does not suffer from this because of the way the overall Price Control works), and possible distortions between terminals.

However it should be possible to re-calibrate baselines at certain terminals as a "half way house" between the current baseline approach and the proposed approach of giving NGG discretion as to what capacity it releases. The advantage of such an approach is that it allows scrutiny to be focused on those terminals where there is an identifiable issue; it allows regulatory stability at those terminals where there is not an issue; and it strikes a balance between the need for regulatory stability and recognition of the fact that, as use of the system changes due to different import flows into the UK, there needs to be flexibility in the system to take account of this.

Secondly BG is concerned as to how Ofgem's proposals will be implemented. As currently drafted, the proposals appear to run the risk of giving too much discretion to

NGG without sufficient regulatory oversight. Clearly this is a problem in the regulation of a monopoly provider. BG is concerned that the result may be NGG tending to under-deliver capacity as this would minimise their risk. The proposals rely on NGG drafting a methodology statement, which appears to be similar to that used for Incremental Entry Capacity Release, which would form the basis of calculation the release of capacity. This would be coupled with publication of a network model which would be open to the scrutiny of shippers. One problem with the methodology statement approach is that creates scope for ambiguity and uncertainty on a number of levels. Firstly the legal status of such a statement may not be clear, making it uncertain how much a legal obligation NGG would be under to release capacity under the terms of the statement. BG has had experience of this type of ambiguity in the past when taking legal advice on the current entry capacity regime. Secondly any statement has the possibility of being interpreted differently which means that there is inevitably greater uncertainty as to how much capacity will be released. It is not clear how differences of opinion between NGG, shippers and Ofgem (all three of whom could have different interpretations) would be resolved. It is of course difficult to comment more specifically without having view of a draft methodology statement, but we recognise that Ofgem has requested NGG to commence work on the statement.

A second problem is the proposal that regulation of release of capacity relies on scrutiny of the network model by shippers. Whilst such transparency is to be encouraged, it is not certain that it is sufficient to ensure the necessary oversight of a regulated monopoly. There are a number of potential issues with such an approach. Firstly, as Ofgem has noted elsewhere in the consultation, there is a potential asymmetry of information between Ofgem and NGG. If this is the case for Ofgem, which is the industry regulator, there is even greater scope for an asymmetry of information and expertise between NGG and shippers. Secondly the proposal has the potential to raise barriers to entry as acquiring the expertise and spending time to understand the model inevitably imposes costs which are likely to be more easily borne by large incumbent players. The net result of these two issues is that scrutiny of the regulated monopoly may be weaker than Ofgem would prefer. It is not clear what role Ofgem would play in this scrutiny of the methodology statement and the network model. However it would be hoped that, as industry regulator with many years experience, Ofgem itself would play a significant role rather than relying on a disparate group of shippers. One solution to improve scrutiny would be to use independent consultants who would be employed by Ofgem to scrutinise the methodology and network model on behalf of the shipping community. The costs for this would be borne by NGG.

Other issues which Ofgem must address if it continues to develop these proposals is how a change in the entry regime will impact those who have already bought entry capacity rights on the assumption that the current regime would persist. When the current Price Control was put in place 5 years there was considerable discussion of the need for regulatory certainty if shippers were to make long term financial commitments in the capacity auctions. This included the need for stability across price control periods. The current consultation does not go into sufficient detail as to how the proposed regime will interact with the regime already in place, both in terms of capacity rights already bought, and in terms of the auctions still to take place (e.g. September 2006). Furthermore the current Price Control includes the rule that 20% of capacity should be held back from the long term auctions to the short term auctions in order to encourage new entrants. Again this raised considerable concern at the time, as many, including BG, were concerned that this would undermine and distort the signals from the long term auctions. The fear was that shippers would base their calculations on the fact that a further 20% of capacity would be available in the short term auctions, and would bid for only 80% of their needs in the long term auctions. It is not clear from the consultation how the new regime would impact those shippers who may have previously relied on the 20% of capacity being available in the short term auctions.

As Ofgem have recognised, the above proposals represent a fundamental change to the regime. BG's concerns do not mean that such change is necessarily wrong; as BG has pointed out in the past the current regime has its flaws. However before proceeding down this route, BG would welcome a more detailed discussion of the issues raised above, and how BG's concerns might be addressed.

*Question 4.2. Do you agree with Ofgem's plans to refine how the revenue drivers work in cases where NGG NTS does provide extra entry capacity, as requested by network users?*

BG agrees with the principle that the revenue allowance for incremental capacity should be fixed in line with NGG's standard costs of capital, and that the return be calculated on the deemed cost for five years and then on the actual efficient costs thereafter. However this issue needs to be considered in the context of the other obligations and risks faced by NGG in the provision of capacity (i.e. the capacity release methodology and the buyback framework).

The proposals on removing baseline are likely to lead to higher capacity prices yet positive TO Commodity charges may remain for winter months because sufficient capacity has previously been released at "baseline" prices. We would encourage Ofgem and NGG to consider these revenue driver effects.

The analysis in Table 10.6 is helpful in setting the trigger level and giving an indication of the costs of incremental capacity, and we assume that this will be used to inform what the appropriate levels of minimum capacity capability is.

*Question 4.3. Do you agree that changes are needed to the arrangements for buying back capacity rights, in particular to ensure a different sharing of risk between shippers, NGG NTS and consumers in respect of capacity which is dependent on large investment projects?*

The comments that follow focus on the existing regime, the sharing of risk between NGG, shippers and consumers, and Ofgem's proposals.

The current buyback regime is set in the context of NGG being required to release the theoretical maximum available capacity as baseline. The corollary of this is that the buyback mechanism is not too harsh because NGG is required to release more capacity than exists normally. Should NGG not have the same obligations, it therefore follows that the buyback risk to NGG reflects the risk it faces with regards to capacity release. If NGG has greater discretion in the quantity of capacity it releases it follows that the buyback regime should be tougher.

BG does not agree with the statement that shippers are protected from any risk in the event that capacity is delivered late. Nor does it agree with the statement that there is an uncapped liability for end consumers. The first assumes that shippers are able to recover all the costs that are imposed by them through the buyback mechanism. Ofgem does not appear to recognise the risks that shippers face when NTS capacity is not delivered on time, if this impacts shippers obligations to take gas. As the UK becomes more dependent on imported gas from sources which are further away and more costly to develop, it is likely that many shippers will have to sign longer term contracts to underpin the necessary investment in these new sources of gas. This is certainly the case today for LNG. Many of these contracts may well have Take or Pay Clauses to which shippers become exposed if they are unable to take delivery of gas because of the late delivery of NTS capacity.

Secondly it takes no account of the state of the buyback "market", or of the market positions of shippers who may or may not be able to pass the costs onto consumers. It is not clear how a shipper with no downstream position can pass on buyback costs to consumers. The only mechanism for recovering such costs is via the wholesale price of gas, the price of which is influenced by many factors of which buyback costs may be only one. Individual shippers do not have the ability to move the market price.

NGG does not face any of these risks, and yet the proposal appears to favour placing more risk on shippers in order to protect NGG and consumers. In the case of NGG it appears odd that a regulated monopoly should be shielded from the risk of carrying out its core business, namely the economic and efficient transportation of gas. It is accepted that a balance needs to be struck between allowing NGG to earn a reasonable return to ensure its financial viability and NGG bearing the responsibility for managing its business. However it is wrong that a regulated monopoly should be shielded from any risk, such as that relating to the construction of pipelines. If NGG is not able to manage issues such as planning risk and construction risk, it raises the question of what it does manage to justify its returns. Furthermore there are other means of mitigating such risks.

In the case of Milford Haven, shippers entered into substantial Preliminary Works Agreements, worth several million pounds, precisely to help manage the risks associated with construction of new entry capacity.

BG does not disagree with the principle that NGG should have the right to buyback new incremental capacity at specified rates. However the price at which NGG is able to buyback should reflect the obligations on NGG to deliver capacity on time, and the risk which shippers face. The price should give NGG sufficient incentive to complete capacity on time. Furthermore such a regime should only apply to genuinely new capacity, namely that which is released under the new price control. On the issue of lower buybacks for capacity which is delivered late for reasons outside NGG's control, such an approach would have to be tightly defined, otherwise NGG will face too little risk for late delivery of capacity whilst shippers bear the costs of not being able to use that capacity. BG agrees with the principle that shippers could agree to vary buyback prices and delivery dates, so long as this is done in the context of robust framework which prevents NGG from gaining undue advantage from its monopoly position. BG also agrees that associated revenues and costs would be treated as excluded income.

Therefore, whilst BG believes that the overall framework (e.g. rules of release for new capacity) should be set in such a way that does not expose NGG to unfair risk, BG does not agree with the proposal to shift more risk onto shippers. The framework should be sufficiently challenging to ensure that NGG is an efficient provider of capacity, and this includes NGG bearing a share of the risk if capacity is not delivered on time. Shippers already bear the risk of not being able to meet their obligations to take delivery of, and supply gas, if capacity is not available. NGG should bear the risk of the costs, whether by buybacks or some form of compensation, of late delivery of capacity.

I hope the above comments are useful. If you have any queries please do not hesitate to contact me on 0118 929 3442.

Yours sincerely,

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