

28 April 2006

Colin Sausman Esq
Associate Director, Transmission
Office of Gas and Electricity Markets (Ofgem)
9 Millbank
London
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Dear Mr Sausman,

I refer to Ofgem Consultation 50/06 “Adjusting National Grid’s revenue allowances when large new entry points connect to the gas transmission system” issued in March 2006 and reply on behalf of Canatxx Gas Storage Limited and Canatxx LNG Limited. This response is not Confidential.

We welcome this Consultation and are pleased with the new Ofgem format for such documents which is very helpful in setting out clearly the issues that face the industry in relation to large new system entry points and the choices that can be made.

Our main comment is that the provision of system capacity both at entry and exit is critical in facilitating a competitive gas market and providing choice to customers at the same time as underpinning security of supply for the UK market. Notwithstanding the gas supply/demand issues during the past winter, and the continuing planning difficulties associated with the development of new storage assets in the UK, we believe that the UK gas regime is fundamentally sound and the NBP represents an attractive source of liquidity to LNG developers which is of critical importance to the UK.

To maintain the attractiveness of the NBP and allow the UK to be an attractive market for LNG, the provision of additional entry capacity is critical in order that re-gasification capability is created, with the ability to accept LNG supplies and get them to the NBP. The cost to consumers of providing such capacity is small in comparison with the benefits of lower long term gas commodity prices and enhanced security of supply.

To that end, we welcome and support the investment made by National Grid in relation to the increase of St Fergus capacity in the period 2000-2005 and now underway to provide additional capacity at Easington, Milford Haven and Isle of

Grain. We believe that the next price control that applies to National Grid must be designed to maintain National Grid's incentive to provide the necessary entry and exit capacity to maintain and enhance NBP liquidity.

Appendix 1 of the Consultation sets out the specific questions that Ofgem have requested views on. This is repeated below with our comments in response to each item given as follows:

Chapter 3

Q1. Do you agree with the proposed scope of this consultation as set out in this chapter, ie covering network modelling issues and the identification of other potentially relevant information?

R1. We agree with the scope of this consultation and support the inclusion of the other relevant information set out in 3.11.

Additional comment

In relation to the dual roles of the UCAs (set out in 3.2 and 3.3), Canatxx is working towards bids in the auctions later this year. To that end, this will be prior to the start of the new TPCR period and would allow National Grid and Ofgem to agree a capex allowance in relation to the provision of entry and exit capacity at Preesall for Canatxx gas. We believe that it would therefore be helpful if ahead of these auctions, National Grid and Ofgem could agree a capex/opex/revenue sensitivity in relation to the Canatxx project which meant that successful bids in the auctions for a certain capacity automatically translated into an adjustment to the capex and opex allowances in the next TCPR period and a corresponding adjustment in allowed revenue.

Q2. Do you agree with the proposed focus on estimating actual longrun incremental costs, for the purpose of setting UCAs for large new entry points?

R2. Whilst we agree in principle with the focus on long run incremental costs, we note that the depletion of the UKCS means that this methodology is more difficult to apply. When, for example, Teesside and St Fergus offshore supplies were rising and capacity was constrained in that part of the NTS, it was reasonable to use an LRMC methodology when looking at incremental capacity at these points. However, with major declines underway at St Fergus, Teesside and Barrow, the LRMC methodology has to rely on a view based on the date of the 'base network'. For example, new capacity in the NW DN area of the NTS (Barrow, Partington, Preesall) would have required

significant investment had it been required prior to 2002 but given the declines at St Fergus, Teesside and Barrow, much lower levels of investment (if at all) would be required from 2008.

Chapter 4

Q1: Do you agree that it might be appropriate to model the "Auctions+" supply scenario and 1 in 20 winter peak demand scenario taken from NGG's latest Ten Year Statement, or would it be more appropriate to consider, in addition to or instead of these scenarios, other potential supply and demand scenarios?

R1. Our understanding is that the 3 scenarios set out by National Grid all assume the same investment and hence network entry capacity by 2008/09 and all assume the same level of firm 1 in 20 gas demand. Given that, we are uncertain as to the impact of selecting Auctions + rather than Global LNG or Transit UK as the scenario (as defined in the 2005 Ten Year Statement)

Further, we do not understand how changes in demand assumptions impact the level of entry capacity given that all gas must have a delivery point. Section 3.5 of the 2005 Ten Year Statement shows a major sensitivity in relation to power generation demand. It is possible that new CCGTs which are located in the centre of the NTS would provide a destination for gas that would, we understand, reduce the level of investment associated with new entry points.

Given that the Canatxx project will also be able to take gas off the NTS, this is also a material benefit in relation to network operations and reducing constraint costs in the event such power stations are built but do not take gas for whatever reason on peak and off peak days.

Q2: Do you agree with the proposed approach to setting the base network, including the proposal to use the same base network (ie, for 2008/09) for all new entrants irrespective of when their project is expected to come onstream?

We agree that 2008/09 represents an appropriate year for the base network modelling and agree that this network should be based on the latest Ten Year Statement supplemented by incremental Isle of Grain capacity following the auctions.

In addition, however, we believe that the material declines in gas flows at St Fergus that have been seen this winter and reported on the National Grid website also need to be taken into account in the modelling. The level of St

Fergus flows is a crucial factor and we believe that, with the completion of the Langed pipeline to Easington, the flows from St Fergus will continue to decline at a high rate, thus releasing capacity for new gas to enter the NW LDZ area of the NTS. The flow assumptions from the LNG site at Partington are also an important factor in relation to NW area NTS capacity.

Q3: Do you have any views on the range or combination of years that the network should be modelled for, given that with the Graphical Falcon model a multi-year modelling period (eg, 10 years or more) is unlikely to be practical, given the difficulty of producing robust long term gas flow forecasts, and given that forecasting for later years (when the new entry capacity is assumed to have come on-stream) may involve a circularity problem?

The key period is likely to be the five years of the next TPCR period as during this time the LNG capacity that the UK needs to secure its position in world markets is likely to be secured. To that end, we believe the focus should be on the period 2008/9 to 2012/13.

Q4: Do you agree that it is appropriate to determine ranges of flow increments for each large new entry point (eg, 20-40 mcm/d, 40-60 mcm/d, 60-80 mcm/d), based on the incremental flow requests submitted by the applicant, and then set a separate UCA for each range? Also, do you agree that if the final capacity bookings signalled in the auctions are in excess of the chosen ranges, a new UCA request will have to be submitted?

R4. We agree with the suggested flow ranges and with a new UCA request for flows outside these ranges.

Q5: Do you agree that it may be appropriate to treat the costs of connecting pipelines differently from other network reinforcement costs incurred to accommodate large new entry points, and if so, how?

R5. We agree that the cost of the connecting pipeline is a contestable activity and should not be part of the UCA. We have no objection in principle to National Grid building such a pipeline on behalf of a shipper or developer but believe the costs should be fully refunded by the developer as they are for exit connections. Conversely, there are a number of other Gas Transporters who have the capability to build and operate such pipelines and so the developer has a range of competitive options. If a shipper funds its own connection however, due account should be taken of the fact that this shipper is also paying 50% of the costs of the connection for Milford Haven.

Q6: Do you agree that cost allocation between entry and offtake should depend on the approach by which the network is balanced and, if so, that costs should be apportioned fully to entry points if a supply substitution approach is adopted?

- R6. We do not believe that the supply substitution approach is appropriate as this is discriminatory, favouring some terminals (existing) over others and not recognising the crucial factor that the worldwide trade in LNG which is vital to the interests of UK consumers has to have excess of re-gasification capacity and for such capacity to exist there has to be an apparent excess of NTS entry capacity.

Q7: Do you agree that is appropriate to use supply substitution for network balancing purposes, in the context of modelling incremental flows at large new entry points, or are there situations in which a load absorption approach may be more appropriate? If we adopt supply substitution, which of the proposed four options would you consider the most appropriate, and on what grounds? Alternatively, would you consider another approach to supply substitution more appropriate, and if so, on what grounds?

- R7. First we believe that the vibrancy of the UK gas market will bring with it new demand and that the higher power generation sensitivity (see Section 3.5 of the 2005 Ten Year Statement) is made more likely as a result of a regime that supports and promotes access for new supplies.

We believe that there are benefits to consumers both in relation to price and security of supply if the NTS is 'oversized' as set out in 4.45. Hence we believe that due account should be taken of these benefits when the UCAs are set with the result that 'excess' capacity is constructed but the costs are borne by the community. One way to achieve this is to use the UCAs for Milford Haven (as Q8 below) or, if higher UCAs are used, to retain the 50% test but increase the period over which the NPV is calculated to 15 years as LNG and storage assets will have long asset lives.

Q8: Do you have any views on what cost data should be used in the modelling work, eg should cost data from the last price control be used (for consistency reasons) or should more up-to-date cost data be used (to improve cost-reflectivity)?

- A8. We believe that the interests of a dynamic market are best served if the cost data as used in the Milford Haven UCAs is used. This is most likely to deliver the long term benefits to consumers that result from attracting investment in LNG re-gasification facilities into the UK.

Chapter 5

Q1: Should Ofgem take into account any of the factors raised in this chapter when setting UCAs for large new entry points, and if so, on what grounds and in what way?

R1. In addition to promoting and supporting competition in gas supply, Cantaxx believes the key determinant of this should be non discrimination between projects seeking UCAs in 2006 and ones approved in 2004 and 2005, together with simplicity, transparency and stability. Hence we believe that all the factors identified in 5.2 are appropriate.

In respect to storage, there is general acceptance that investment in storage is something that will act in the interests of UK consumers and is required as the 'de facto' UKCS storage field declines (as UKCS production falls). As such, it is appropriate to take this into account in the overall regime design and make adjustments to the regime that make it easier for gas storage projects to be developed.

Q2: Are there are any other factors, not mentioned in this chapter, that Ofgem should take into account when setting UCAs for large new entry points, and if so, on what grounds and in what way?

R2. Canatxx believes that there can be a risk of stranded assets if the regime is too encouraging of new investment. However, investment in the centre of the network (for instance increasing capacity to flow gas to the Interconnector from the Midlands) is significantly less risky than investment to increase capacity of a network leg (such as Milford Haven or St Fergus). This could be taken into account by adjusting the UCAs with a 'stranded asset' risk factor which would be low for investment between Midlands and Bacton but higher for more specific entry related investment such as related to Milford Haven.

I trust the above is helpful, if however you wish to discuss any of the above points please do not hesitate to contact me.

Yours sincerely

Graeme A J Thorne