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Dear John

Future arrangements for Great Britain's gas quality specifications consultation: Ofgem's response

Thank you for the opportunity to respond to your consultation on gas quality specifications in the context of the Great Britain (GB) gas market, and for allowing us to submit a late response to this consultation. We do consider this to be an important issue but we have needed recently to focus our resources on the shorter term issues associated with next winter.

We are grateful for the consideration that the Government has given to this issue as we think that it is important for all gas customers. As you are aware, we ourselves have been committed to addressing a range of regulatory issues relating to gas quality for some time¹.

As you appreciate, given the move from being largely self-sufficient for our gas supplies to being increasingly reliant on imports which may have quality specifications that are not within GB's limits, the issue of gas quality is an important issue. Ultimately, restrictions in GB's gas quality specifications relative to other countries will result in higher costs for GB customers and could potentially restrict some sources of supply.

In summary, we are supportive of the conclusions that the DTI has reached but are of the view that it is necessary to keep this under review to a committed timetable. We additionally consider that work needs to be undertaken by National Grid (NG) to understand the scope for the provision of ballasting and blending services on its system. To this end we are repeating our proposal of September 2004 to review the relevant commercial and regulatory arrangements (potentially including incentives on NG) to investigate ways in which the provision of such services by NG could be encouraged.

In this response we:

¹ In September 2004, Ofgem sought to establish a gas quality review group with market participants to consider issues relating to gas quality. See 'Establishing a gas quality Review Group – Gas quality open letter', 219/04, Ofgem, 20 September 2004. Ofgem has also recently approved a number of Uniform Network Code (UNC) modification proposals that relate to gas quality specifications at network entry points (UNC 019, UNC 049, UNC 069).

- provide our assessment of the options presented; and
- set out the areas where we consider further work is necessary.

Assessment of options presented

The consultation presents two principal options for gas quality specifications. These are:

- the “**no change**” option, which retains the current GB gas quality specifications (as defined in the Gas Safety (Management) Regulations 1996), requiring the blending / processing of off-specification imports so that the gas composition complies with the existing limits; and
- the “**change**” option, under which the GB gas quality specifications would be revised, thereby enabling gas imports from a wider variety of sources without the need for processing.

We note that both of these approaches are likely to lead to significant costs to customers; the “no change” option will lead to increases in “upstream” costs (such as costs of the development and operation of the necessary gas processing facilities), and the “change” option will lead to increases in “downstream” costs (such as the replacement / conversion of at-risk gas appliances).

We note that research undertaken during Phase 2 of the exercise suggested that the costs associated with the “change” option could be significant, estimated at between £2.2 billion and £14.7 billion. In addition, this research indicated that the potential costs associated with the “no change” option may be considerably lower (estimated at between £400 million and £500 million) and some additional safety risks associated with the “change” option would be avoided.

On the basis of the cost and safety considerations highlighted by the research, **we support the “no change” recommendation presented in the DTI consultation.** We also agree that it is appropriate to continue to monitor changes in appliance design and combustion technology, as well as developments elsewhere in the energy market to assess whether the “change” option may become a more compelling approach in the future.

Given the importance of these issues, we feel it is important that a clear process is defined by the Government through which such developments will be monitored. This should include the definition of the party that has responsibility for tracking relevant developments in appliance design and combustion technology, and a clearly defined process for the escalation of any issues that are subsequently identified. One potential approach would be for this role to be included in the terms of reference of the Joint Energy Security of Supply (JESS) working group, with any issues identified being highlighted in the working group's bi-annual report.

Areas for further work

We consider that further work in this area should focus on two key areas:

- promoting transparency in the assessment of opportunities for blending and ballasting by producers; and
- continued analysis of wider European issues.

Opportunities for blending and ballasting

In the event that the Government decides that the “no change” option is the appropriate way forward, there are a number of options for dealing with gas that is outside of GB gas quality specification. The processing and blending of gas to bring off-specification gas in line with GS(M)R standards can be undertaken at a number of points on the supply chain, including at source, at terminals, or on NG’s National Transmission System (NTS).

For the most efficient method of treating gas to be determined it is important that all parties can understand the costs of treatment at these different points.

The arrangements for treating gas upstream of entry into the GB system will clearly be assessed by market participants, as has already occurred for a number of pipelines and facilities. We are however concerned that at the moment the scope for either blending or processing gas by NG, including the costs of these services, has not been fully explored. This indicates a need for NG to carry out studies into the technical feasibility of blending / processing gas and the potential costs associated with NG provision of these services.

As noted above, we have already undertaken numerous initiatives to facilitate the engagement of both NG and the wider industry on these issues. As you will be aware this has resulted in NG considering the potential for blending gas at Bacton. However we consider NG has the potential to play a significantly larger role in the provision of blending and ballasting services to the market than is currently the case. As mentioned above, the role for NG should include extending studies such as that being undertaken at Bacton to all NTS entry terminals.

In light of the DTI’s conclusions, and the subsequent need to minimise the cost to customers of the “no change” option, we consider it essential that producers of off-specification gas are able to make an efficient comparison of the cost of blending and ballasting gas at different points in the supply chain. We consider this can only be achieved in the event that NG:

- a) has the capability to provide such services at different locations on the NTS; and
- b) publishes cost reflective and transparent tariffs for the provision of these services.

As a consequence, we propose initiating a review of the relevant commercial and regulatory arrangements (potentially including incentives) to investigate ways in which the provision of such services by NG can be encouraged. We consider it would be appropriate for this review to be progressed through a working group comprising both NG and wider gas industry participants. Given the urgency of the gas quality issues outlined above, we suggest that this work commences immediately after the Government response to the consultation has been published.

Wider European issues

A natural extension of work focused on promoting the publication of cost reflective and transparent tariffs for the provision of blending and ballasting services by NG is to promote similar initiatives in Europe. Ultimately, we consider the most efficient approach to the “no change” option would allow producers of off-specification gas to assess the relative efficiency of processing gas at source with the cost of processing services provided by transmission system operators across Europe.

To this end, we are undertaking initiatives with other European regulators to understand the impact of the varying gas quality standards on the wider European gas market, and also by placing ourselves at the forefront of the work that the EU is undertaking on gas quality issues.

As an example of this, we are tabling a paper in relation to gas quality and interoperability in a European context as part of the European Regulators' Group for Electricity and Gas (EREG) Gas Regional Initiative. This is intended to initiate work to gain a better understanding of these issues and, where they are thought to be creating barriers to gas flows, to consider possible solutions.

We encourage the DTI, alongside other stakeholders, to continue to consider developments in the gas quality arrangements across Europe as a whole, and their resulting implications for the GB market. We would welcome discussions with the DTI and other stakeholders on the most appropriate way of coordinating these efforts to maximise their effectiveness.

I hope this is helpful. We would welcome the opportunity to continue to liaise with you on these issues – both in relation to any short term issues ahead of winter 2006/07, but also in respect of further studies looking at longer term solutions.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact me.

Yours sincerely

Sonia Brown
Director, Wholesale Markets