Note of Economic Regulation Worksteam – 01 December

Time: 10:00am-12
Venue: Ofgem London Offices

Chair: Sonia Brown

Attendees:

Name	**Organisation**
David Odling	UKOOA
Stefan Leedham	EDF energy
Alison Russell	Centrica
Fiona Lewis	BP
Sean Waring	IUK
Mr Cattoor	Distrigas
Sofia FERNANDEZ AVENDANO	Total
Carl Foulkes	EON
Matt Golding	National Grid
Angela Love	Poyry Energy Consulting
Peter Taff	Independent consultant
Charles Ruffell	RWE Npower

1. Minutes of 9 November Meeting

The group agreed that the minutes of the 09 November meeting would be agreed at the next workstream meeting on 12 December.

2. Strawman

Ofgem produced three regulatory strawmen[1] based on one unregulated and two hybrid approaches which were circulated to the group in advance of the meeting and formed the basis of discussions. Sonia Brown (SB) asked whether there were any comments on the strawmen.

David Odling (DO) asked what standard of service any facility would be aiming for and suggested that it may be inefficient for a processing facility to be fully operational 100 per cent of the time through the provision of a "super solution". As an alternative DO noted that a more efficient solution could be achieved if the facility were available 80 per cent of the time given that processing may not be required on a continuous basis. SB highlighted that ultimately the market would decide the level of service required through the user commitment that they provided to the party responsible for construction of the facility.

SB suggested that prior to considering the standard of service that would be acceptable it would be necessary to define the product that would be provided. As such, she asked for National Grid Gas's (NGG) thoughts on how they would operate a facility if they were to provide services for gas processing and the type of service that they would offer. Matt Golding (MG) stated that he thought it was premature to consider operational issues and outlined that there were other issues to consider such as the appropriate resilience of the plant and the volume of the gas that would need to be covered by the service. He suggested that these issues may become clearer through the tender process. DO made clear that

[1] These strawmen can be found on the gas quality area of the Ofgem website: www.ofgem.gov.uk

parties would simply want to ensure that MGG were not gold plating any service they may offer.

Henri Cattoor (HC) considered that shippers with transit contracts in Belgium would not be willing to amend their contracts in order to facilitate non GS(M)R compliant gas entering IUK. HC further considered that shippers would not want to change their transit or IUK contracts if the cost of building and using a processing facility was targeted on the users of a specific piece of infrastructure, i.e. IUK shippers. HC thought consideration should be given to spreading the costs of constructing and operating a facility at a terminal amongst all users.

SB highlighted that at the last meeting the group had reached the conclusion that a strategic solution would not be appropriate given that NGG would not have a full understanding of the appropriate size to build that facility. She suggested that users would have a better understanding of this given that they would have sight of the terms in their contracts relating to gas quality and would therefore be able to signal this through user commitment.

Angela Love (AL) suggested that it would be appropriate to keep the contract issue in mind if it was unlikely that the specifications outlined within IUK contracts would change. SB stated that the question of IUK contracts was a different one to that being considered by the workstream. As such, she outlined that the group had been tasked with considering whether parties transporting gas through IUK would need to pay any costs associated with processing that gas. She emphasised again that it would be inefficient to simply smear these costs across all users as this would remove any incentive to invest appropriately.

HC outlined that he did not consider that parties would be willing to change the gas quality specifications within IUK contracts as they would not want to incur costs associated with this or those associated with processing the gas. SB outlined that this information would need to feed into the scenario development workstream and the consideration of the extent to which there may be gas quality issues may affect the GB market. SB also noted that if Fluxys decided to change the IUK flange gas quality requirements to accommodate EASGAS specifications then IUK shippers would be obliged to change their contracts.

<u>Hybrid Approach 1</u>

SB asked whether there were any specific comments on the Hybrid 1 approach.

Alison Russell (AR) highlighted that under a pure user commitment approach there was a possibility that the signals provided through the tender process may not be sufficient to meet market requirements. She outlined that she therefore favoured an approach in which NGG would have a higher degree of discretion with respect to the investment that it made and under which it could earn a higher rate of return. DO agreed with this view and stated that it would be difficult for users to offer commitment more than a few years in advance. SB pointed out that under the Hybrid 2 approach NGG would earn a higher rate of return for taking investment risk. AR suggested that it would be appropriate to define the meaning of a higher rate of return as well as the level of associated risk. She suggested that it would be appropriate to target the costs as far as possible and to provide incentives on parties to book their capacity at the facility early.

SB asked whether the general feeling was that parties did not support the Hybrid 1 approach. Charles Ruffell (CR) considered that this approach made it difficult for National Grid to set a test in order to decide on a sufficient level of investment as it was for users to signal this through the tender process. As such, he considered that the Hybrid 1 approach was too rigid.

SB asked whether there was a preference for an option away from the Hybrid 1 approach. She highlighted that under the Hybrid 2 approach there would be scope for NGG to invest simply on the basis of user commitment signalled through the auction but that NGG would not receive a higher rate of return for this. She emphasised that the rate of return earned by NGG should be consistent with any risk taken in terms of capital investment.

DO highlighted that there were fairly significant reserves of gas on the UKCS which could not be developed due to gas quality issues and that these would not be developed if a processing facility were not built. SB suggested that a market test to determine whether a processing facility would be appropriate would ensure that all parties had an opportunity to feed into discussions.

CR stated that there was not any difference between out of spec gas and LNG and asked why the former should not include the cost of processing. DO highlighted that the processing requirements for LNG would be known and given that it would be owned by one party it would be economic to construct this facility but that this was not the case with offshore supplies.

SB emphasised that Ofgem did not want to preclude third party investment but that if NGG were to produce cost estimates for providing gas processing facilities, this would offer a comparator to others thinking of investing within the provision of a service such as this.

Hybrid Approach 2

SB asked whether there were any specific comments on the Hybrid 2 approach.

AR outlined that while it would be appropriate to target costs as much as possible, it would seem appropriate to include some element of insurance. SB stated that NGG would be taking a view on the appropriate size of the facility based on all of the information received and would have the discretion to invest as it saw appropriate. She outlined that if NGG decided to take a risk with investment it would have the opportunity to earn a higher cost of capital. She suggested that the increased returns should come from those parties that wish to use the facility and did not signal this user commitment to NGG. She pointed out that the risk that the facility was not used would be borne by NGG.

Sofia Avendando (SA) asked whether the costs associated with the processing facility would be targeted on those parties bringing gas to the GB market that was out of specification. SB responded that it would be necessary for the group to consider issues of cost targeting. She suggested that this may need to be at a terminal or sub-terminal level given that it is not possible to identify specific shippers delivering out of spec gas.

HC asked whether this would preclude parties with out of spec gas from bringing this to the GB market. SB responded that the aim was to allow gas that conforms with specifications in Belgium to flow to GB and target the associated cost of processing this gas at those users bringing it to GB.

HC emphasised thatit was unlikely that parties would change the specification of gas flowing through IUK. In response, DO highlighted the Theddlethorpe example where all of the gas contracts were changed simultaneously to allow more to flow to the GB market.

Sean Waring (SW) considered that there would need to be a simultaneous change of all of these contracts otherwise users would not want to commit to this. SB agreed that all users would need to sign up to a change in contracts if IUK were to commit to this. She suggested that those parties bringing gas to the GB market that did fall within GB specifications should be held neutral to the costs of processing and that this could be addressed through bilateral arrangements with those parties bringing gas to GB that falls outside of the specifications. SB noted that if the facility were used the costs would ultimately be paid by GB customers but if it were not used these costs would fall on the companies themselves.

Fiona Lewis (FL) asked whether the blending and ballasting processes would be combined as part of the same facility. MG responded that this was more technical detail that would need to be developed at a later date.

AR asked how it would be possible for NGG to over-invest in the facility and SB responded that this would be the case if the facility was not utilised. AR pointed out that it was unlikely that the facility would be fully utilised at all times. SB recognised that to address this a test would be put in place to monitor utilisation of the assets over time and that these arrangements would be developed through the industry workstream. DO suggested that due to the potentially changing gas quality conditions in the future it may be the case that this test would need to be flexible to adapt to this. SB stated that the test would need to address this issue over the entire life of the assets.

DO considered that option 2 had the best chance of success. SB also pointed out that this solution could operate in parallel to an unregulated approach. She outlined that this was particularly apparent given that any facility constructed and operated by NGG would provide a cost benchmark for parties considering constructing another facility to provide this service.

SB asked the workstream whether they considered there should be an obligation placed on NGG under the Hybrid 2 approach to offer a processing service, for example whether there should be an obligation under generic licence conditions.

SW asked whether the construction of the facility would have implications for the exit arrangements and SB responded that if the potential construction of a gas processing facility were not going to impact the arranegements at entry there would be no reason why changes would need to be made to exit.

DO asked whether the suggestion was that there should be an obligation on NGG to offer a minimum volume of the service. SB stated that a licence obligation upon NGG would require that if a third party were to approach NGG regarding access to gas processing facilities NGG would be required to enter into a constructive commercial discussion with that party. She outlined that, in recognition of the costs associated with this type of assessment the third party would need to be willing to pay some, if not all, of the associated costs.

MG outlined that this would be an expensive service especially given that NGG has not been responsible for these types of assessments previously.

Sharif Islam (SI) outlined that it would be conceptually attractive for others to be able to offer a gas processing service alongside any services offered by NGG as this would also place a competitive pressure on NGG. However, he outlined that he was not sure that an obligation upon NGG to provide this assessment service should be applicable at all entry points. SB noted that this would be a light-touch obligation and there would be the assumption that NGG had the core competencies to undertake this process. MG agreed that it was difficult to see how NGG would provide a regulated service to the market without some kind of obligation to do so.

The group agreed that it would be appropriate to place an obligation upon NGG to undertake technical feasibility tests where it was approached by a third party requesting this service.

Unregulated approach

SB asked the group whether they were keen to develop further the unregulated approach.

The group agreed that the Hybrid 2 approach was the most appropriate solution to develop further and that any unregulated solution developed by a third party could operate in parallel to this.

3. Hybrid 2 Processes

The group discussed the appropriate steps that would need to be taken in order for NGG to construct and operate a processing facility. The group's discussion got as far as debating the cost targeting options. However nothing was agreed, so Ofgem took an action to draft some ideas on cost targeting for the group to discuss at the next meeting. The attached note outlines the processes agreed by the group and also includes a section on cost-targeting, which Ofgem drafted to assist in discussions at the next meeting.

4. The Way Forward

The group agreed that the Hybrid 1 approach was not appropriate and further hybrid discussions should be based on the Hybrid 2 with the potential for unregulated approaches to be developed in parallel.

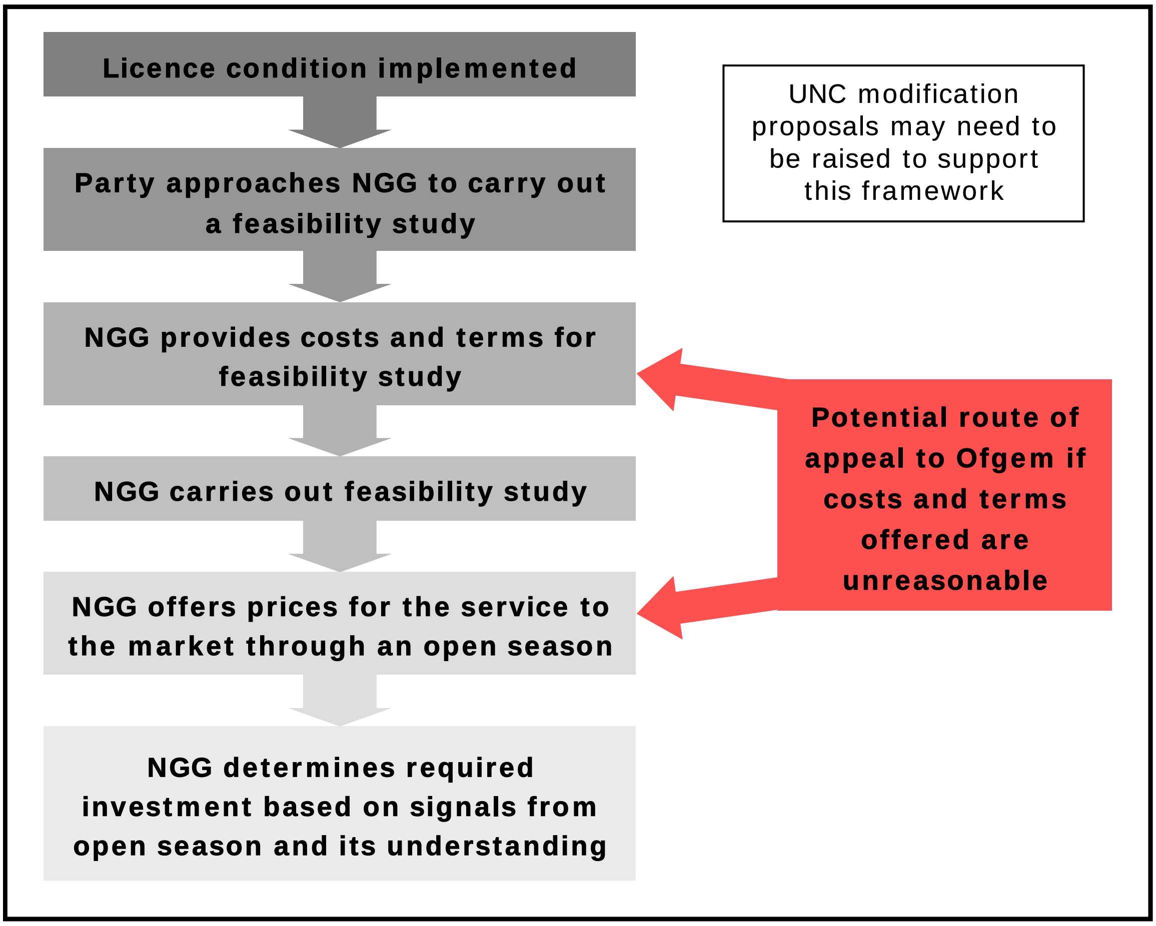
Action: Ofgem to draft a note outlining the processes agreed by the group under the second hybrid approach and circulate it to the group ahead of the next meeting. Ofgem to also include in note draft text on cost targeting for the group to discuss at the next meeting.

Next Meeting of the Workstream: 12 December 2006

The Hybrid approach

The following steps outline the arrangements that would be put in place in the event that a gas processing facility were constructed under a Hybrid 2 approach.

Arrangements to assess feasibility of building a facility



Implementation of a licence condition

A new licence condition would be introduced placing an obligation upon NGG to enter into discussions regarding the potential construction of a gas processing facility when approached by a third party.

The obligation would require NGG to offer reasonable terms a for technical feasibility study, on a non-discriminatory basis, for a gas processing facility at a particular entry point. The scope of the obligation would require that NGG must offer terms for gas processing facilities proposed at any entry point to the NTS

Process to assess feasibility of a facility

Under the terms of the licence a third party interested in the construction of a gas processing facility would be able to approach NGG and request that it undertakes a technical feasibility study at a particular location. There may be economies of scale if the party were to approach NGG as part of a group of market participants interested in using a processing facility at a certain point on the system.

NGG would provide an estimate of the costs for the pre-work services that it may enter into contract with the party to provide. NGG would be given the discretion to determine the level of risk sharing that it would be willing to accept on any given project.

There would be a route of appeal to Ofgem at this point, the provisions for which would be contained in the licence, and these may be evoked in the event that NGG did not offer reasonable terms and costs for the provision of these services.

Once NGG had reached an estimate of costs the third party would decide to either accept the cost and service agreement that NGG draws up or reject it.

Provision of the service to the market

Following completion of the feasibility study, NGG would offer prices for the service to the market, along with the associated terms and conditions. This would be carried out through an open season process.

There would be a route of appeal to Ofgem at this point, the provisions for which would be contained in the licence, and these may be evoked in the event that NGG did not offer reasonable terms and costs for the provision of these services.

On the basis of the open season process as well as NGG's understanding of the extent of the issue associated with gas quality NGG would take a decision on whether and how much to invest in the processing facility.

Receipt of revenue by NGG

NGG would receive a standard cost of capital, consistent with the transmission price control, for the capacity of the facility in which it invests in response to the user commitment signals provided through the tender process.

NGG would receive a higher cost of capital for any additional capacity in which it invests over and above that signalled through the tender process. Alternatively, NGG could sell this additional capacity through an auction and be given the opportunity to retain this revenue. However, if NGG chose to invest in additional capacity which was not utilised it would not receive any revenue for this.

Cost targeting

The costs of construction and operation of the facility would be targeted at those using the infrastructure linked to the relevant entry point. To facilitate this, an obligation could be placed upon all shippers bringing gas to the GB market, through the relevant piece of infrastructure, requiring them to enter into contracts for the provision of gas quality services.

Users would book the required capacity at the processing facility either through the initial user commitment tender or through the auction process. The decision on whether to participate in the initial tender or the auction would likely depend upon the visibility that parties had regarding the volume of gas they would likely flow and therefore on the associated processing service that they would require.

Where this obligation applies to parties not flowing gas that falls outside of GB specifications, they could enter into bi-lateral arrangements with parties that are, to ensure that they are appropriately compensated for having to comply with obligations that have arisen as a result of others behaviour.