

**Draft Note of Gas Quality Economic Regulation Work stream
09 November 2006**

Chair: Sonia Brown (SB)

Attendees:

| Name | Organisation |
|----------------------|-------------------------|
| Alison Russell (AR) | Centrica |
| Angela Love (AL) | Poyry Energy Consulting |
| Sean Waring (SW) | IUK |
| Alex Barnes (AB) | British Gas |
| Fiona Lewis (FL) | BP |
| Sofia Avendando (SA) | Total |
| Carl Foulkes (CF) | E.ON UK |
| Stefan Leedham (SL) | EDF energy |
| Paul Roberts (PR) | National Grid |

1. Minutes of previous workstreams

SB suggested that workstream participants should send any comments that they have on the minutes from the previous workstreams to Hannah Cook.

2. Comments on the meeting of the last workstream

SB outlined that Ofgem had received a number of comments regarding the approach discussed at the last meeting of the workstream. In this respect, she highlighted comments received from Distrigas regarding their concern that the implementation of cost targeting at any processing facility constructed at Bacton could impede the development of a single European market given that the gas quality specifications would not be harmonised. She explained that Distrigas also had concerns with a polluter pays principle given that not all parties would be polluting the system with out of spec gas. She outlined that they had a concern regarding the fact that it would not be possible to "tag" molecules but that to try and enter into commercial arrangements to compensate those not polluting would be complex and difficult and the incentives involved were unclear.

SW confirmed that these were the concerns expressed by Distrigas. He stated that their concerns relating to issues of cost targeting were that there were a number of ways that that this could be achieved. He also outlined that there were problems with respect to the fact that shippers may be unwilling to change their contracts due to the costs associated with this. He set out that Distrigas therefore favoured a form of cost socialisation.

SB highlighted that EDF had also made comments on the discussions at the previous meeting. SL outlined that while he agreed that the concept of a feasibility study was a good idea, he had concerns that a shipper may commission this study and then not be successful in obtaining capacity at the facility. He therefore suggested that it may be appropriate to smear the costs associated with the feasibility study across those that were successful in obtaining capacity. AL noted that an alternative way would be to give priority to those parties that had paid for the feasibility study. SB outlined that she had a preference for an approach under which the costs would be smeared across all parties successful in obtaining capacity.

CF asked whether it would be appropriate to refund the cost of the facility to the party that approached NGG if this were to go ahead and then smear the costs across those parties successful in obtaining capacity at the facility. PR suggested that the costs of the feasibility study could form one aspect of the prices that parties paid in the tender process.

SB asked whether it would be appropriate to smear back costs on parties on a volume basis. CF stated that the party that commissioned the study should get the associated cost back and that the costs should then be smeared across all parties successful in obtaining capacity, on a pro rata basis.

SB asked whether, if the facility did not go ahead, the shipper should be required to pay all of the costs associated with the feasibility study. AL suggested that NGG should determine whether the party would have to pay if the facility did not go ahead following the feasibility study. SB pointed out that there would likely be significant costs associated with the completion of a feasibility study and that NGG would always therefore want parties to commercially underpin this given that they would not get any allowed revenue for this under the price control. SB clarified that NGG could potentially carry out a feasibility study itself if it thought this was appropriate and reap back the associated costs through the auction process. CF pointed out that NGG could potentially carry out such a study in conjunction with a group of shippers. SB agreed that this could be the case but clarified that NGG would be exposed to the risk associated with this and that it would not be underpinned by the regulatory asset base.

SB outlined that Peter Taff (PT) had also emailed in some comments following the discussions at the previous meeting. She stated that his comments had been made in a similar vein to those from Distrigas in that they related to concerns regarding cost targeting. She set out that PT had concerns that only the Fluxys system would allow tracking of gas quality and that it was unlikely that parties would rely on bilateral deals between one another unless there was transparency regarding gas quality on the Fluxys system. She stated that PT considered that it was unlikely that the required elements of the process would come together due to associated complexities. SW suggested that Fluxys may therefore be in a position to target the costs of any facility appropriately but AL pointed out that there were issues about the level of transparency on the Fluxys system.

AL asked at what point the facility would be constructed and whether the open season would be forward looking. SB set out that an element of the decisions on this would need to be taken by NGG but suggested that if it were risk averse it was likely that NGG would hold an open season sufficiently far in advance of the build to get signals from users regarding the appropriate size of the facility. PR clarified that NGG would definitely want some assurances that it would obtain a return on any investment.

AL asked whether once the feasibility study was complete NGG would provide the party with terms and conditions indicating the date that the facility would likely be constructed by. PR outlined that NGG would most likely prefer a more flexible approach. SB suggested that the processes would likely work similarly to any commercial arrangement in this respect. AL asked whether, if the arrangements were to work in a similar way to commercial contracts, risks associated with non-delivery would be addressed. SB stated that there would likely be a number of innovative ways that this could be dealt with and that, as such, if the facility were delivered early there could be optionality associated with this while if it were delivered late then both parties would share this risk. CF pointed out that this would likely work the same as the commercial risk associated with construction of any large asset.

PR outlined that as NGG had not been involved in construction of facilities of this nature previously parties would need to be mindful of associated uncertainties. SB suggested that parties involved in this process would need to negotiate with NGG on these issues. She outlined there may be situations where NGG's reasonableness may be questioned and emphasised the importance of the appeal process to deal with this especially given that NGG would be the sole provider of this service.

SB asked whether there were any other comments on the discussions at the previous meeting. FL asked whether, during the auction, parties would need to provide NGG with user commitment for the entire duration of the asset life. SB outlined that there would not be any test agreed with the Authority regarding whether or not the project would be approved given that NGG would have the opportunity to earn a higher upside reward and the Authority would not sign off on that. FL suggested that it was less likely that parties would want to provide user commitment for this length of time. SB emphasised that this was the benefit of the Hybrid 2 approach in that NGG would be taking the risks associated with this in the pursuit of a potential reward.

AB suggested that there were two issues to consider in this regard; how long the asset would be required for and the higher rate of return that NGG would be able to earn in return for taking risks associated with investment. AL asked whether it would be appropriate to have a reserve price in an auction to ensure guaranteed return for NGG. PR stated that it would be possible to have a price schedule for this and SB outlined that this would be based on the supply curve associated with the provision of a service at the facility.

AR suggested that the risks for NGG associated with investing in the facility for a period out to 15 to 20 years may not be as large as envisaged on first glance. She stated that although some parties processing requirements may change over time, it was likely that there would always be some element of gas that needed to be processed and these requirements would simply transfer from some parties to others in the market.

SW asked whether it would be sensible to allow parties access to cheaper prices if they were to book further into the future. SB suggested that this could be discriminatory as the underlying cost associated with this capacity at the facility would not have changed.

FL asked whether as NGG would have discretion to build more than that signalled through user commitment it would also be possible for NGG to take the view that although a requirement was demonstrated through the auction process it was sensible to build less given that a certain amount would be co-mingled. SB noted that this could be possible particularly if NGG had the ability to buy back capacity at the facility.

CF pointed out that if parties were not able to achieve a discount from booking further into the future there would not be any incentive to do this. SB responded that there was a risk that if parties did not signal their commitment the facility may not be built and a risk that they may not have access to capacity at the facility even if it were built or that they may be exposed to high prices. She set out that if parties understood these risks they should demonstrate commitment. She emphasised that she would not be comfortable with the use of long-term discriminatory pricing given that it would not only introduce complexity but that it would create commercial risks associated with how much gas could flow to GB.

PR asked what the product was that was being offered. CF outlined that this was likely an issue that would be discussed between interested parties. SB clarified that the product was ultimately a service to bring out of spec gas within the GB wobbe range. AR explained that at the last meeting the group had agreed that it was just the wobbe range that would be dealt with by this service and that the service would also only apply to entry not exit.

CF asked whether there would be a user commitment hurdle on any projects. AL suggested that any such hurdle would become apparent through the feasibility study. CF emphasised that the market would need to have transparency on this in order to understand the level of commitment that they would need to provide. SB highlighted the case of LNG projects in which the parties involved in the open season process would know the hurdle that they needed to reach in order for investment to be taken forward. SB suggested that when NGG defined the product that it would be offering through the auction, it would be appropriate to provide with transparency regarding the investment hurdle that would need to be reached, in response to their requests for this.

3. Cost targeting under the Hybrid 2 approach

SW suggested that if costs were to be targeted, it would be necessary to assume that the entry specifications on IUK would need to be changed to allow parties to flow gas that falls outside of GB specifications. He stated that if parties had not booked capacity at the gas processing facility for the entire volume that they intended to flow through IUK they would need to pay overrun charges for the processing capacity that they needed and had not yet purchased. SB clarified that to support this approach there would need to be long-term auctions through which parties could bid in to gain access to processing capacity on a volumetric basis. She stated that this would place an incentive on parties to correctly book the required capacity and also create incentives for a secondary market.

SB asked whether, if certain shippers had not booked sufficient capacity at the facility to process the gas that they intended to flow and there was not enough available capacity at the facility, it would be necessary to cut off those shippers. SW suggested that if there was additional capacity at the facility it could be offered to these shippers at a higher cost. SB asked whether, if there was not sufficient capacity at the processing facility, IUK would be willing to let this gas into the pipeline without knowing whether it would be able to flow to the GB market due to gas quality concerns. SW thought that IUK would be able to continue to flow gas to GB but that the gas would simply exit the pipe at the level at which it would be possible to process the gas.

CF suggested that arrangements could be put in place to address situations where there was not sufficient capacity at the facility to process the gas flowing through IUK and this could be based upon the same principles as those used in cash out. AL pointed out that it would not be possible to tag which parties were flowing what gas and when. AB suggested that it wouldn't be a case of who was flowing gas that was out of spec but rather that all parties would likely be flowing gas that was out of spec. SB outlined that this got to the crux of the point made by Distrigas, that if one party were to bring gas onto the system that was out of spec this would have implications for all others in terms of processing. She therefore outlined that the costs of processing should be targeted at those bringing on gas to the system that was out of spec.

SB outlined that there was a potential alternative framework for cost targeting under which infrastructure companies would underpin the investment decisions made by NGG. PR asked whether this would require changes to the Gas Act and

SB responded that the model would require that shippers would bid in for capacity at the facility. SA suggested that under this approach the different infrastructure providers could contract for this gas as a joint unit.

SB noted that this approach would incorporate an element of cost targeting but that the problem would be that it would not be possible to accurately target the costs associated with a gas processing facility. SA pointed out that at some points on the system it was possible to identify the platforms inputting out of spec gas to the system but she recognised that this may not be the case at IUK.

SW considered that cost targeting would be most effectively administered by Fluxys. SB set out that parties' would need to accept that the costs may not be targeted accurately and asked the group whether they had any views regarding ways that this could be addressed. She suggested that compensation could be offered to parties that did not create the problem which could be done on either a short or long term basis. SW clarified that it would be important to target costs at upstream parties bringing out of spec to the system.

SB asked whether workstream participants had any preferences between the different approaches. AR outlined that she was struggling to see how the approach would balance on the day if any facility were built purely on user commitment. SB outlined that she would envisage that on certain days there would be enough parties with requirements above the capacity they had booked and enough below their allocated capacity to balance out requirements.

In response to requests for clarification on the two approaches, SB outlined that there would be:

- A shipper commitment approach under which long term auctions would take place and shippers would bid in for capacity at the facility. There would be an assumption that the facility had been built on this basis and shippers would flow gas in accordance with this. Where shippers had not booked relevant capacity at the facility they would be required to pay overrun charges.
- An infrastructure commitment approach under which NGG would get a signal from infrastructure companies who would provide user commitment for a facility to be built. These companies would place a charge on shippers on exit to recover the associated costs.

FL pointed out that a shipper may put gas into an infrastructure facility that fell within the relevant specifications but, due to co-mingling, would be out of spec by the time it exited the pipeline. SB outlined that if parties were certain that their gas was within spec this may create commercial incentives to reveal this information and receive compensation. AB suggested that an alternative cost recovery system would be to socialise these across all parties. SB pointed out that the infrastructure commitment approach would socialise these costs across all parties using a certain piece of infrastructure but that to socialise the costs across all market participants would place NGG in a licence breach.

SW stated that he had a preference for the shipper commitment approach as it would be more efficient and would place the relevant choices with shippers. SB pointed out that the economic outcome from both models would likely be the same given that shippers would be negotiating with parties in both instances and the approach would simply determine who shippers negotiated with. SL asked whether it would be possible to implement a mixture of both approaches and SB responded that it would.

PR asked whether Ofgem had a preference on either of the options and SB responded that essentially the economic outcome would be the same under either approach and that she therefore did not have a strong preference. CF pointed out that the gas would have to be processed and that ultimately it was simply a question of the way that the payments were attributed to individual users. SB set out that to promote competition it would seem more appropriate to adopt the shipper commitment approach. She noted that this approach would need to incorporate overrun charges and that if parties understood that they were not flowing out of spec gas but that it was being polluted by others they would seek to obtain greater transparency on the Fluxys system.

FL suggested that if two shippers had purchased capacity at the processing facility and a third had gas that was out of spec it may be possible for the third shipper's gas to be co-mingled to an extent that would mean that this shipper would not need to pay for processing services. SB stated that all parties would need to pay for processing facilities if they were flowing out of spec gas.

AL asked who would receive revenue from the penalty administered for overrun charges. CF suggested that this revenue should be recycled to those parties in balance in terms of the processing capacity that they booked and then used.

4. Way Forward

SB outlined that if the economic framework supporting any processing facility was sufficiently developed then the workstream had achieved its objective. AB stated that he was concerned that there would not be sufficient user commitment from parties for NGG to construct a facility and that a socialised approach would be more appropriate. SB noted that this was why Ofgem had begun the economic workstream to address potential issues associated with gas quality. She outlined that Ofgem did not think it would be appropriate to build a strategic processing facility to address issues of gas quality. She outlined that with respect to the issue of user commitment, the Hybrid 2 approach had been developed to address this by placing incentives on NGG to take risks associated with investing in the processing facility in return for potential rewards.

PR outlined that there would need to be a number of meetings to discuss the issues associated with the Hybrid 2 approach in further detail.

AR asked what the intention of the report that Ofgem would be publishing was. SB outlined that it would set out the models that had been considered by the workstream and the conclusions that had been reached with respect to the appropriate model going forward.

AB asked whether the licence change proposed in the workstream would be consulted upon and SB confirmed that it would be. SB asked whether NGG would be willing to comply with any early requests for feasibility studies on the basis of user commitment prior to the proposed licence condition being put in place in light of the fact that getting the condition in place would take time. PR noted that he would need to discuss this internally.

SB outlined that Ofgem would send through draft versions of the document to interested parties to get any comments that they may have on the direction of policy to ensure that it is consistent with the discussions through workstream.